PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

December 16-17, 1985

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, December 16, 1985, at 3:30 p.m. and continuing on Tuesday, December 17, 1985, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Black
Mr. Forrestal
Mr. Keehn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger

Mr. Guffey,1/ Mrs. Horn, Messrs. Melzer and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Broaddus, R. Davis, Kohn, Lindsey, Prell, Scheld, Siegman, and Ms. Tschinkel, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross, Manager for Foreign Operations, System Open Market Account

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1/ At this meeting, Mr. Guffey voted as alternate for Mr. Balles.

Mr. Roberts,1/ Assistant to the Chairman, Board of Governors
Mr. Gemmill,1/ Staff Adviser, Division of International Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Griffith, First Vice President, Federal Reserve Bank of San Francisco

Messrs. Balbach, J. Davis, T. Davis, Lang, Rosenblum, Scadding, and Thieke, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Cleveland, Kansas City, Philadelphia, Dallas, San Francisco, and New York, respectively

Messrs. McNees and Miller, Vice Presidents, Federal Reserve Banks of Boston and Minneapolis, respectively

1/ Entered meeting after action to approve minutes of meeting held on November 4-5, 1985.

Transcript of Federal Open Market Committee Meeting of
December 16-17, 1985

[Secretary's Note: The minutes of the previous meeting were approved without objection.]

MR. CROSS. Statement--see Appendix.

MS. HORN. Sam, when you get [foreign currency] proceeds from intervention, in what form are they held?

MR. CROSS. Well, we invest them in a series of different kinds of investments aimed at getting a market rate of interest and keeping them very liquid. We try to keep them liquid, if possible, so they will be usable. We have some in
--a whole series of different instruments in different countries, depending on what is available.

CHAIRMAN VOLCKER. How much do you have in government securities now?

MR. CROSS. We have some in government securities.

CHAIRMAN VOLCKER. How much?

MR. CROSS. A modest amount.

MR. TRUMAN. $1-1/2 billion.

MR. CROSS. Well, not so modest. We have $1-1/2 billion out of the total of $12 billion of Treasury and Federal Reserve holdings.

MR. PARTEE. Are they mostly deposits, Sam?

MR. CROSS. A lot are in one form or another. There are some in BIS deposits and some in

MS. HORN. Basically, you don't get so much of a currency relative to the size of the market that you have to go away from publicly issued debt or government debt?

MR. CROSS. We have a lot in I am not sure I understand your--

CHAIRMAN VOLCKER. We, in fact,

MR. CROSS. Right.

CHAIRMAN VOLCKER. I don't know to what extent we are in public markets at all.

MR. TRUMAN. Well, most of these countries do not have the kind of short-term instruments that are available in the United States--Treasury bills that you can invest in--except for Switzerland, which has a small amount. Neither Germany nor Japan has a Treasury bill market in the sense of a short-term government paper market such as we are used to in the United States. As a consequence, we

the deposit facility of the BIS, which essentially goes into the Euro-market.

CHAIRMAN VOLCKER. It might be worthwhile, just to see what you are doing with our money, for you to send out a little memorandum.

MR. CROSS. I would be happy to submit a memorandum showing where all of these assets are but, as Mr. Truman said,

we do have them in short-term investments; the aim is to get a market rate and to keep them very liquid.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. I would like to change the focus toward policy reactions and interest rates in other countries. Suppose that U.S. interest rates dropped further--that there was an easing in U.S. monetary policy. Would that likely show up as a weaker dollar or would you think that the Japanese and West Germans might be inclined to let interest rates ease in their own countries?

CHAIRMAN VOLCKER. Or both?

MR. BOEHNE. Or both?

CHAIRMAN VOLCKER. Both.

MR. PARTEE. How much of each?

MR. KEEHN. Sam, related to that, what kind of [mood do] the markets have regarding the fundamentals, excluding intervention? Before, we had worried very much about a precipitous decline in the value of the dollar. In certain circumstances, is there still a pervasive feeling about that or do circumstances--

MR. CROSS. I think at the present time the attitude is generally more that there has been a substantial decline in the dollar and that the central banks are reasonably satisfied with the range in which the dollar is now trading. So, there is not the same kind of fear that it might tumble very, very rapidly as there was some weeks ago. But obviously, it's still a possibility.

MR. KEEHN. Well, excluding the policy changes or activities on our part, such as intervention--the issues Ed was talking about--is there any sentiment out there that we could see a stabilization and a rise in the value of the dollar?

MR. CROSS. Well, there are certainly some people who think that after a time the authorities will either lose interest or not continue this operation and that fundamentally the dollar has some strength to it. So, there are some [views] on both sides. Of the amount of investments that we have, $1.7 billion are in government securities.

MR. BOEHNE. I think what you have just said is that foreign considerations are at least somewhat less of a constraint now than they were several weeks ago.

MR. CROSS. Well, I think what I said was that with the dollar declining at that time, there was quite naturally concern that that would continue or that [the pace] would increase and it would fall very, very rapidly. Now, there is certainly some possibility of a further fall, depending on a whole lot of things. But the fact that the dollar [has been trading in] these ranges for some period of time has given a little more breathing space--a little more feeling that maybe it has stabilized, since it has tended to be a little more stable around these levels.

MR. MORRIS. At the last meeting you expected that the market would test the resolve of the central banks. Do you think that attitude has passed? Do you think the danger of a rising dollar is behind us?

MR. CROSS. Well, I am not sure whether it was the last meeting or the one before that. But certainly I don't think we had as big a test on the up side as we might have expected in those circumstances. There was a test during that period around the middle part of October; and the response of the central banks was rather forceful but it was not a massive operation nor really major pressure. We spent amounts that were certainly a lot larger than we had been spending, but it was not a massive operation. Since September 22, all the G-10 countries together have spent around $13-$14 billion. During the February-March operation intervention was around $10 billion or so. But this is not all [dollar related]. There have been some pressures within the EMS and a substantial amount of intervention relating to EMS pressures, particularly against the Italian lira and some of the other European currencies which might be expected to devalue.

VICE CHAIRMAN CORRIGAN. There is another way of looking at it, too, just in terms of institutional sources of demand for dollars. A lot of that demand has come from Japan, of course, and in Japan there are two sets of institutional factors that tend to cut the other way. One is that most of the pension funds [and] insurance companies have a 10 percent limit on the percent of their portfolio that can be in any non-yen currency, and almost without exception they are crowding up against the 10 ten percent. Now, that won't keep them from buying dollars completely, but it means that they can only buy dollars prospectively to the extent that their overall asset base grows. Secondly--and I think this is particularly relevant in the case of Japan--according to the reports that we get, through much of the second and third quarters Japanese corporations, of course, were spinning off a tremendous amount of excess cash and were making very short-term dollar investments in very large quantities. And the reports that we get have begun to suggest that, partly because of the changed economic situation, that very large supply of short-term demand for dollar-denominated assets may not be there prospectively in anything like [the way] it was retrospectively. I don't know how all that fits in, but it is one of the factors that tend to work on the other side of the equation.

MR. MELZER. I would say, just as a general comment--I am not closely in touch with the psychology of that market--that the fact that there might be a perception that we have reached target levels and that we have achieved some kind of stability actually could increase the vulnerability to a precipitous decline because those that were short dollars and riding it down very likely have covered those [short positions]. So that takes a bit out of the market. Now, I don't know whether that is the case, Sam--whether you feel positions are pretty well squared off--but if those short positions are out of the market, there could be a chance for a more precipitous decline.

MR. CROSS. That certainly is possible. It is also argued, at least by the Japanese, that there may be some heavier investment demand--that some are waiting to make sure that they get the bottom [price] for the dollar and are going to be coming back in to push it the other way. So, there are the cross currents.

MR. MARTIN. Let me ask a naive follow-up question. Let us suppose that these negative factors that Jerry and Tom are talking about do come to center stage. What direction would that enormous capital outflow take then? What are their alternatives?

MR. CROSS. You mean if they do not invest in the dollar?

MR. MARTIN. If they want to switch away from dollar investments very substantially, where do they go?

MR. CROSS. Partly it is not a matter of switching away from dollar investments; it is whether one comes into the dollar investments with or without cover. One can still be investing in these dollar investments and covering, and that would offset much of this.

MR. BLACK. Would that be possible in the case you were talking about, Jerry, where they are limited? As long as they are covered, are they okay?

VICE CHAIRMAN CORRIGAN. Either way, it doesn't take all that much of a shift in terms of the very short run. I think part of what is going on here is people putting a great deal of emphasis on these psychological threshold levels of 200 yen and 2.50 marks. If it moves away from those on the up side, I think people are prepared to do something about it. If it moves away on the down side, that is pretty hard to deal with.

MR. BLACK. I was just thinking about these institutional pensions having a 10 percent limit on their dollar [assets]. But if that is covered, that limit is not--

VICE CHAIRMAN CORRIGAN. I think the limit does apply even if it is covered. Doesn't it, Sam?

MR. CROSS. I think it is 10 percent of the [unintelligible].

VICE CHAIRMAN CORRIGAN. Yes.

MR. CROSS. It is certainly true that for now they have been convinced that the central banks are serious and they see some resistance on the up side, whereas there are still statements in one form or another which can be read by the market as suggesting that maybe some further downward move is expected and desired by some. So I would say--

CHAIRMAN VOLCKER. I will make a profound statement: If they really have some assurance that it's not going to go up, it will go down.

MR. CROSS. That is profound and sums it up. I think that concern about how long is the staying power is a longer-term consideration, but for now they're reasonably confident that there will be resistance on the up side but not on the down side.

CHAIRMAN VOLCKER. Having explored our uncertainties in that area, we will ratify the few transactions since the last meeting.

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN VOLCKER. Without objection. Let's turn to domestic open market operations.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Questions?

MR. FORRESTAL. Peter, is the Treasury back on schedule now with its auctions or do they have some backlog still?

MR. STERNLIGHT. They are just about caught up now. They were backed up and had to follow the passage of the debt ceiling bill with an immediate same-day auction of 3- and 6-month bills, and they already had announced some of that month-end batch of coupon issues--the 2- and 4-year issues. Those will be coming along, I think, later this week and next week and that puts them pretty much back on schedule.

MR. FORRESTAL. Also, you mentioned Texaco and their being closed out of the commercial paper market. Are they picking that up through bank lines or--

MR. STERNLIGHT. For the moment they are paying off paper. They have bank lines that they really do not consider will hold given the material changes that have occurred in the company's prospective fortunes. And they have alternative plans for achieving the liquidity to continue meeting their paper maturities which [involve] that they are just in the process of developing, we understand.

CHAIRMAN VOLCKER. Other questions? A question occurred to me as you were talking: Would you judge that we are engaged actively in monetizing the Treasury's deficit?

MR. STERNLIGHT. We do our usual thing: increase our holdings to offset currency in circulation and rising required reserves.

CHAIRMAN VOLCKER. Would anybody like to ratify our usual thing?

MR. PARTEE. The answer, for the record, is: No, we are not monetizing the Federal debt. I move to ratify.

MR. RICE. Second.

CHAIRMAN VOLCKER. Without objection. Now we'll turn to Mr. Axilrod, who will introduce Mr. Lindsey.

MR. AXILROD. Thank you. To provide background to the Committee's discussion of the role the monetary aggregates might play in policy formulation, Mr. Lindsey will summarize the analysis of the aggregates and their characteristics contained in the recently distributed staff paper of which he was the chief author. I will then briefly outline the possible implications for the usefulness of the aggregates in policy implementation next year.

MR. LINDSEY. I will be referring to the package of charts entitled "Materials for Staff Presentation to the FOMC". [Statement--see Appendix.]

MR. AXILROD. Mr. Chairman--

CHAIRMAN VOLCKER. I think maybe we ought to stop you now and ask for any questions we might have of a quasi-technical sort. I have a question. Maybe I'm wrong, but when I look at this velocity change that you're projecting for this year [unintelligible] focus on GNP for the first part of '86. When is the last time we had such a change in the velocity of M1?

MR. LINDSEY. Well, in 1982 velocity of M1 fell 5.6 percent. This year it's falling at 5-1/4 percent. That was an unprecedented decline in 1982 and there wasn't anything--

CHAIRMAN VOLCKER. Literally unprecedented? Go back to the 1930s.

MR. LINDSEY. Well, that was a fair statement. I was thinking post-war period.

CHAIRMAN VOLCKER. If that decline was all that big in '82 and surprised us, that quarterly model didn't come in very far off in that period.

MR. LINDSEY. Well, the quarterly model has an interest elasticity that rises as market rates rise. And market rates started out in 1981 at pretty high levels. So the quarterly model, as rates came down, picked up a good bit of that increase [in M1]. You are correct. That's less the case in 1985 when rates started out at lower levels.

CHAIRMAN VOLCKER. If you look at that quarterly model, it looks like '81 was way down but '82 and '83 not so much. Presumably, in '81 it was the transition to NOWs.

MR. LINDSEY. That's right; nationwide NOWs were introduced at the first of the year.

MR. PARTEE. [Unintelligible.]

MR. MORRIS. My recollection is that we were very surprised at the strength of M1 in '82. I don't--

MR. AXILROD. Well, we were surprised at how low interest rates got. If we had known in advance that that was going to happen, we would have been less surprised.

CHAIRMAN VOLCKER. [Unintelligible] centered around [unintelligible]. Governor Partee.

MR. PARTEE. I was just going to refer to chart 2 here too, Dave, which is the lagged relationship. It certainly doesn't look very good. Indeed, it looks to me as if these last four quarters have been just about as bad as it can get if one assumes that the only reason we follow M1 is for its predictive relationship to GNP. Did you try other kinds of lags and more complicated lags or anything like that in your effort to make sense of this?

MR. LINDSEY. We did, in several respects. I plotted velocity relationships for 1-quarter lags as well, but I also plotted moving averages for money growth and for GNP growth--say, 2-quarter moving averages--and then tried different lags on that. I had a whole set of charts there. Averaging growth over two quarters, it turns out that the connection between M1 and GNP is best with a 1-quarter lag over the '80s, though it isn't great. But it's better than the other alternatives we tried. In a sense that relationship was reflected in the chart I showed you with the 2-quarter lag in M1's velocity; that gives it a chance to pick up [the relationship], in effect, over the two-quarter period. The leading relationships in the '80s, which I am not at all sure are as systematic as the monetarists would have us believe, show up best for M1 and less so for M2. I think part of the reason for a leading relationship there is because when interest rates change, the demand for money gets affected sooner than does spending. So, when interest rates change--which some might argue is what really is driving the process--money growth adjusts first and GNP growth adjusts subsequently. And it looks as though there's a leading relationship from M1 to GNP even though in some sense the fundamental cause, some would argue, could be the change in interest rates.

MR. PARTEE. Interest rates, yes.

MR. MORRIS. More than some, I would imagine.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. When you weight the components of M1 by some transactions measure or in some more esoteric and wonderful way and you use a 1-quarter or 2-quarter lag, how is the predictability of velocity of this--whatever you call it--weighted aggregate measure? How does that track? Is it any better or any more predictable?

MR. LINDSEY. We have been doing some work on two different kinds of weighted aggregates: the divisia aggregates originated by

Bill Barnett; and more recently, a Fisher weighted index that in effect uses the turnover rates to weight the various components of M1, or in fact, all transactions deposits. So with a very low weight, MMDAs which are checkable and money funds which are checkable are included. If you examine that measure's growth in recent years relative to M1 and M1A it cuts the difference almost in half. Maybe the best way to summarize the results is that since both M1A and M1 suffer problems over this period, it's also true that this new measure suffers some problems as well. We have done work on this. I'd be glad to send some of it along in more detail.

MR. PARTEE. You're multiplying through by the velocity?

MR. LINDSEY. In effect, the growth rates of the various components are weighted by their share of expenditure in GNP; that is the precise way it's done. And that, in turn, is related to their debits divided by their stock or by their turnover. You have to make some adjustments to take out financial transactions and currency exchange transactions to get to the GNP transactions that you need. But that's the basic idea.

MR. AXILROD. Thank you. Well, we have been examining these various weighted measures--Barnett's measures, Paul Spindt's measures, and this one that Dave just mentioned that is in effect velocity weighted rather carefully. And we are trying to think of ways we might be able to get even more academic input into the process, although some of this material has already been published in the academic press, and a rather large literature is developing. It has a certain appeal as a way of at least supplementing the unweighted measures of the aggregates because there are various ways of taking varying degrees of liquidity or moneyness into account. One thing to keep in mind--and these are the early days--is that it doesn't really tend to solve economic problems. That is, it might help in the way things look. If, for example, there is going to be a big shift out of market instruments or some lesser kind of money-type deposit into other deposits, that shift is going to appear in more rapid money growth relative to what the Committee said or what it expected. In an unweighted average, growth will be even more rapid growth; in a weighted average, it will be a little less rapid. But the economic problem in interpreting the deviation will still be there. You're not going to change the necessity of interpreting the aggregates [by using] a weighted average. Instead of the difference being between 6 and 10 percent when there is a shift, it might be a difference between 6 and 7 percent. So [the explanation] will seem easier, but in effect the economic issues are the same: Should you offset the 7 percent? Should you offset the 10 percent? But, there is something to be said for the weighting--in my view in any event.

CHAIRMAN VOLCKER. Well, if there are no more particular questions, you can proceed.

MR. AXILROD. Well, Mr. Chairman, I fear the conclusions that I have will be gravely anticlimactic. I believe one of the clearest conclusions from Mr. Lindsey's analysis is that the aggregates are still in a state of flux--

MR. MARTIN. Yes, I'd say that!

MR. AXILROD. --in the sense that there has not been enough time to get a reasonably certain handle on the impact of past deregulation and on the behavior of depository institutions and their customers under varying economic and financial circumstances. And, of course, there will be an additional and final deregulatory step early next year that will provide even more flexibility and choice for banks and depositors. Thus, it is very difficult to suggest at this time that more weight should be given to the aggregates as a whole in policy implementation next year than was given this year. On the other hand, I would tend to argue that we do not have compelling evidence that even less weight should be placed on the aggregates as a whole. We do, I think, have some evidence that under current circumstances the weight on the aggregates should be redistributed in some degree among them--or at least that M1 should be judged in light of what's happening to M2 and M3. While uncertainties abound, it does seem to me that we're in the process of moving toward an M2 with an interest responsiveness that is low relative to M1, as Mr. Lindsey has pointed out. That in itself would tend to argue for giving the broader aggregate a bit more weight than it has had in the past, particularly in periods when market interest rates may be changing substantially. In those circumstances, there could be large effects from interest rate changes on the demand for narrow money, given the sizable amount of savings funds now in that aggregate that shift readily between M1 and other components of M2.

I certainly do not mean to suggest either ignoring M1 or quickly reacting to small changes or large potentially short-lived changes in M2 relative to path. M1 cannot be ignored because it does, of all the aggregates, contain the highest proportion of transaction balances and to that degree is sensitive to future GNP. I think that was borne out in Mr. Lindsey's analysis of the difference between the concurrent velocity and the lagged velocity, which is smoother than the concurrent. M2 cannot be relied on completely because it contains large elements of savings that in turn depend on attitudes toward wealth and other factors affecting the propensity to save. The relationship between M2 and GNP thus is not all that tight or predictable either, as compared with M1. Perhaps I'm really suggesting no more than what the Committee has been doing implicitly, under one interpretation at least, over the past year. Over that period the relative moderation in M2 growth--at least its moderation relative to path--as well as in M3 can be viewed as having been a significant, but not necessarily decisive, counterforce to the strength of M1 in the implementation of policy. In that sense, policy responds more to the aggregates when all are relatively strong or all are relatively weak than when any single one goes off course. If it is right that M1 is in process of becoming subject to significantly more interest sensitivity than M2, at least at around current market rate levels, then it may be desirable for the Committee to consider adopting a 1986 range for M1 that is wider than for M2. The tentative ranges currently have the same width; a wider M1 range would allow for larger swings in M1 in response to potential interest rate changes over the year. It would also be consistent with our view that forthcoming deregulatory changes, apart from their long-run structural impact, would affect M1--either up or down--mainly depending on bank strategies with respect to NOW, savings, and money market deposit accounts, if indeed they have any significant effect at all. Whatever the numerical specifications of the ranges, though, and whatever the weight of the aggregates relative to each other, it's hard to see that the Committee can implement policy next year with any less judgmental interpretation than in recent years. Uncertainties about the aggregates are inherent, given the rather long period over which banks and depositors adapt their behavior to a deregulated environment and given the perhaps longer period it may take before the new regularities in their behavior can be detected and relied on with confidence for policy purposes.

MR. MARTIN. Steve, first of all, I want to express what I think is the consensus around the table--don't smile--that you and your associates have done a commendable job in laying out the experience and in doing a certain amount of statistical analysis and being forthcoming with regard to the difficulties of using the monetary aggregates at this time. The message I take from this is that we're talking about various components of the several aggregates in terms of varying degrees of moneyness--varying degrees of savings characteristics versus transactions characteristics. And that suggests to me that the work that you've already begun to do, and that you said you have considerable academic comments and literature on--namely, some kind of weighting of the components of the aggregates--would have the merit of continuing our ability to communicate what we know and can surmise about the behavior of these various balances. It seems to me that if you have in train a set of presentations that you've done work on, which you've alluded to, that would be a logical follow-up to a good piece of work on the existing aggregates to communicate with us what you know and are finding out about weighted aggregates. I wouldn't have made this little comment a year or maybe even six months ago or maybe not before I read the work that you've done here. But it seems to me that this presentation argues for another presentation which would inform us about the weighting that you alluded to on a transactional basis and on a turnover basis of the components. If we are to communicate our findings with the Congress and with the public, it seems to me that (a) we have a duty to communicate once this group is comfortable with some weighting of the components and the production of such an aggregate; and (b) that it could give us--admitting all of the drawbacks that Steve has alluded to--some kind of an aggregate in addition to the ones we have or perhaps in replacement of M1 down the road. So, I'm encouraged by what you've done. I strongly support your hint that we could have other presentations with regard to weighting. And I think a transaction weighted component aggregate M1 might be easier to communicate than one weighted by some more intriguing interest-differential [unintelligible], from what little I understand about [the divisia] approach.

MR. AXILROD. We will do this work and, of course, present it as it develops, Governor Martin. I would like to stress that the work is really quite experimental in the sense that the statistical basis for the weighting is not that strong. We have done surveys in the Research Division to develop data and, while it's as good as we think we can make it under present knowledge, the statistical basis is not that strong. Secondly, I would like to stress that, at least in my own view--and it's probably important to get more input from others in the profession--I don't think it solves the policy problem. It may have certain presentational advantages but I don't think it solves the policy problem of whether or to what degree the aggregates are a good guide to [the Committee]. That, I think, is not solved by this.

MR. PARTEE. I would just attack one thing: I must say that I'm bothered about this business of making a shift from turnover to something related to GNP because of the fact that we have so many debits related not to GNP but to financial transactions. And it seems to me that that's an unsolvable problem.

MR. AXILROD. Yes, that's among the issues.

MR. PARTEE. I rather prefer the interest rate differential approach. It would measure the degree of liquidity, you might say, in the mind's eye of the public in looking at the various aspects--I suppose partly because you wouldn't have that difficulty. It would be a straight reading of the interest rate differentials and the weight.

CHAIRMAN VOLCKER. A straight reading of the interest rate differential between a demand deposit and a market rate.

MR. AXILROD. Well, that index has a problem, Governor Partee. That's why I really would stress again the experimental [nature] of both of these. The way that was initially measured--and one has to try to deal with it--when interest rates got to 17 percent the degree of moneyness in the RP became less than when they were at 5 percent.

MR. PARTEE. I see your point, yes.

MR. AXILROD. And that seems counterintuitive. So that was a big difficulty in that particular measure. So, both these measures have certain statistical properties in them that are difficult, as well as the fact that the analysis of the economics is just barely beginning.

CHAIRMAN VOLCKER. Well, I don't think it would hurt any--I started to say just for the heck of it, but it may be a little more than just for the heck of it--to show what some of these weighted measures look like at the next meeting.

MR. AXILROD. We will do that.

MR. BOEHNE. I think Pres is onto something and I agree with what he said. I think there is a broader point to be made here. Substantively, I think what you said is that the aggregates are probably no worse, but they are certainly no better--and from an analytical point of view I think that is right--than they were a year ago or six months ago. Maybe they are a little worse, but--

MR. PARTEE. They have been terrible indicators for the past year.

MR. BOEHNE. But I think they are worse in another way, aside from the analytical, and that is from the communications aspect of [policy]. M1 was very useful at one time to help us rationalize and defend what needed to be done several years ago. But it has fallen from grace on a pretty wide scale. And while I think there are advantages to hanging on to the hope that it could somehow be rehabilitated, it seems to me that it has been wounded so badly that it would be very difficult for a considerable period in the future to base any hard medicine on something like M1. Therefore, it seems to me that it goes beyond the analytical problems that we have with M1. It just would be very difficult from a public relations and a political point of view ever to base--no, ever is too long--in the foreseeable future to base any kind of bitter pill on something like M1. We ought to continue the work and I think the suggestions that Pres made are worth pursuing. But I think we are dealing with something that is much bigger than just analytical work. Generally, I find that whereas a year ago people still asked about M1, it is not even asked about very much anymore.

CHAIRMAN VOLCKER. Its burial may be a bit premature; it depends upon what happens to the economy over the next few months.

MR. BOEHNE. I think it is on a sick bed.

CHAIRMAN VOLCKER. I would agree with that. We'll see whether it has had a partial recovery; I'm not sure it will return to full health. We would have to have one heck of an increase in the economy in the next 3 to 6 months, which is contrary to the projections we have before us.

MR. MARTIN. 12 percent nominal.

CHAIRMAN VOLCKER. Mr. Black can defend it.

MR. BLACK. No, I'm going to admit, Mr. Chairman, that it has been rather sick; I guess in retrospect I should have recognized that it was sick sooner than I did. But I don't think that's the key issue. I think you just put your finger on the key issue: What it is going to do from now on. We have been through a very unusual period. We have had a sharp decline in inflation and inflationary expectations; we have had extensive deregulation in the depository markets; and we may have had a decline in real interest rates. This certainly has done something to change it for the time being but it may be the case that in the future it will resume some of its former characteristics. It may be that it will proceed at a lower rate of secular growth. For example, if we have had an element of savings introduced into the NOW accounts and other checkable deposits, as I assume we have, and if this has brought about some improvement in cash management policies, as I think it has, then that may mean that all we are really going to have after we are through this period--which is largely behind us, I think--is a slower rate of growth in velocity on a secular basis. And if that is the case, then that can be as predictable as it has been in the past. The paper certainly implies that just because it's slower, it doesn't mean that it is worthless. The truth of the matter is, of course, no one knows for sure what it is going to do. So that suggests that we ought at least to weigh with caution the idea of throwing it out completely, because for long periods of time in the past it has been a rather useful thing to look at. I agree with Pres that a divisia index makes sense conceptually; I have always felt that that made more sense than anything else since obviously M1 is not the only thing that has some characteristic of money. There are a lot of things that do. And if we could somehow or another get the right weighted average, conceptually, that to me is the kind of thing that we want. Because if we don't target something of that sort, then all we have left is interest rates and that involves a necessity of saying what the appropriate level of interest rates is. That is very difficult for anybody to do and there is nothing in theory or in empirical studies that suggests what the appropriate level ought to be. But when we get to these divisia indexes I guess there is going to be a problem of data availability and also probably a problem of control of these--although I am hopeful that we can move in that general direction because that's what all my instincts tell me is really the best way for us to go.

CHAIRMAN VOLCKER. There are a few other guidelines that one could have other than interest rates.

MR. BLACK. Well, they would be very akin to that. You could have free reserves, you could have borrowed reserves, but--

CHAIRMAN VOLCKER. Exchange rates, prices--

MR. BLACK. Well, but to achieve a given price level, you have to have some way of moving the economy one way or another; I think that ought to be our goal ultimately, but you have to have a handle to move it in the right direction. The exchange rate certainly would be one; I probably should not have not oversimplified to that extent.

CHAIRMAN VOLCKER. I am not quite sure that I followed all of this complex analysis delivered to us orally. Looking at these interest rates, it's clear that super NOW rates are more sluggish than Treasury bill rates. But before we had super NOWs and all of these [deposit] rates were zero or when we had ceiling rates, movements in market rates were sharper relative to the transactions rates. Therefore, one would have thought velocity would now be steadier relative to history rather than less steady.

MR. MORRIS. The difference, Paul, is that the old M1 was transactions balances; it's because people had a strong incentive to minimize the amount they held in non-interest bearing form. The incentive, if not completely gone, is seriously impaired. Therefore, if there are savings balances in those accounts, they are going to be much more sensitive to changes in interest rate differentials than pure transactions balances.

MR. AXILROD. One other way of looking at it, Mr. Chairman, is that a lot of these NOW accounts are simply, in effect, the old savings accounts re-designated. And all of this volatility that we are observing as interest rates go up and down, would have occurred only in M2 and not at all in M1. So it is simply transferring--

CHAIRMAN VOLCKER. That raises the question of whether M2 used to be more volatile.

MR. AXILROD. Well, that was the disintermediation time. I haven't checked back, but my impression is yes. In the last two years M2 has been reasonably stable while M1 has been quite volatile. I stopped myself short of saying directly [that the Committee might want to] put a little more weight on M2. I thought I was implying it very indirectly.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. There are a couple of straws in the wind, but not much more. One thing that I think is true that bears on all of this is that today even compared, say, to 1980, the public at large is much more sensitive to interest rates and relative interest rates in managing their financial asset portfolios. That's just a hunch, but it does look that way to me. The second thing that may be true is that in terms of general liquidity characteristics of financial assets held by the public that are not bank-issued--in other words institutionalized savings such as thrift-plan type savings, pensions, IRAs and so on--a good deal more of the nonbank-related financial asset holdings of the public may be perceived by the public to be less liquid than bank-issued financial assets. Again, I don't know this to be true, but my hunch is that it is. And if both of those things are true, that also may help to explain why the public, including the business sector, does seem to be on the one hand more aggressive in shifting among classes of bank-issued financial assets, while at the same time increasing their holdings of nonbank-issued financial assets. The problem with that, if it is true, is that it brings into sharp focus in my mind the point that Dave mentioned in terms of what it implies about the interest sensitivity even of M2 but especially of M1. If you argue that M2 in some sense is less interest sensitive and, therefore, is a better "indicator" than it used to be or even better than M1 is, but you also accept the point that Dave made that it really isn't the quantity that matters, it's the price that matters, then it seems to me that you can get yourself into a real box, if it turns out that M2 is less sensitive but yet the economy itself is in some sense more sensitive. That to me makes this question of what you look at more difficult in one sense but maybe easier in another sense. That's because if the public is more sensitive and if there is anything at all to this question of liquidity of bank-related instruments versus nonbank instruments, it's another reason to believe that money growth relative to GNP is going to be permanently higher than it was in the past and velocity growth is going to be smaller at least than it was in the past.

The other point that has been made about drawing some consolation from the fact that the broad aggregates, M2 and M3, look more respectable and can help us interpret, or at least roll with M1 in this recent period, I am not very sure about. For example, in the case of M3, I cannot help but think that M3 is as weak as it has been at least in part because of the way banks are financing things these days. They are issuing standbys and all these other off-balance-sheet instruments. Somebody else is doing the financing and the bank itself no longer has to issue the large CD until something goes wrong and the borrower comes to the bank to execute a standby. I think if you make any allowance for the tremendous explosion of off-balance-sheet contingent financing by the banks, as opposed to the traditional bank financing of business credit through issuance of large CDs, one at least has to question whether in fact M3 is telling us the same things it used to tell us insofar as that broad measure of bank liabilities is concerned.

MR. PARTEE. If you compare [it with] credit growth?

VICE CHAIRMAN CORRIGAN. Well, it reinforces the view that credit growth is telling us something other than that the number is big. I think it is telling us that the growth of credit is not some kind of statistical aberration. This widening out of the spread between both--

CHAIRMAN VOLCKER. What is it telling us about the economic outlook?

VICE CHAIRMAN CORRIGAN. What it tells me is that we probably are putting a lot of bad debt on the economy. I don't know.

CHAIRMAN VOLCKER. If the debt is so high, and that is what we should be looking at, does that say that the economy is going to begin expanding after two years?

VICE CHAIRMAN CORRIGAN. I don't see any burst in the economy. What worries me is that if the economy doesn't expand--

CHAIRMAN VOLCKER. Then it seems to me that credit isn't telling you anything in the way you look at these monetary aggregates as telling you something about the future of the economy.

VICE CHAIRMAN CORRIGAN. I think it is telling you that in the course of a not spectacular economy you are seeing a further deterioration of balance sheets in the economy.

CHAIRMAN VOLCKER. That's different; it's not a leading indicator.

MR. PARTEE. The point though, Paul, is that M3 doesn't tell us anything either.

CHAIRMAN VOLCKER. Well, a simple factual question is: What would a new aggregate--M3 plus commercial paper--look like?. That must pick up most of the off-balance-sheet financing.

VICE CHAIRMAN CORRIGAN. No, it doesn't. Not anymore.

CHAIRMAN VOLCKER. How else--Euromarket?

VICE CHAIRMAN CORRIGAN. For example, yes.

MR. AXILROD. Mr. Lindsey has some data on L, which is M3 plus commercial paper plus Treasury bills.

MR. LINDSEY. We ran the L measure through a St. Louis-type so-called reduced-form equation that uses current and lagged quarterly growth rates along with a fiscal variable to predict the current growth in GNP. If you look at 1985, the error there in predicting GNP was 3.3 percentage points; it predicted faster GNP than actually transpired. If you look in the paper at the results for some of the other aggregates, though, that [result] is better. For example, M1's error was 7.9 percentage points. Interestingly enough, though, debt did almost as badly as M1 in 1985. It missed by 7 percentage points on the growth rate of GNP.

MR. MORRIS. Since 1982, M3 and L have had a better performance than the other aggregates.

MR. AXILROD. Anything that grew less than M1 is going to have had a better performance.

VICE CHAIRMAN CORRIGAN. There is another point one can make about M2. If you take small time deposits out of M2 and put them in M3 on the grounds that they do not have overnight liquidity, and you take the remaining institutional money funds out of M3 and put them in M2, then M2 grows by 14 percent rather than 7 percent. That's the idea.

MR. PARTEE. They were in the zero growth area; you put in all that has been growing.

VICE CHAIRMAN CORRIGAN. Which is the point I was trying to make: If you look at these things all these different ways, you can make at least a plausible case that the "moderate" growth of M2 and M3 maybe isn't so moderate in its own way.

CHAIRMAN VOLCKER. Maybe. If you take that line, why are all these aggregates rising so much faster than the economy?

VICE CHAIRMAN CORRIGAN. That was the thrust of my first set of comments. I said they were straws in the wind. But it gets to this point about whether there is a difference--in addition to what we know about inflation having come down and all the other things--that would traditionally point to velocity growth being slower. Given that, is there any plausibility to the argument that financial assets issued by banks and held by households are now perceived to be that much more liquid than financial assets not issued by banks? In the current circumstances that would mean that the public would want to hold more of those relative to the less liquid nonbank issued financial assets.

MR. MARTIN. I think that argues for a further study of the turnover of components of each of the aggregates. I will broaden my comment here as--

CHAIRMAN VOLCKER. [Unintelligible] got a lot of Treasury securities.

MR. AXILROD. Mr. Chairman, a slightly impressionistic answer--

VICE CHAIRMAN CORRIGAN. That doesn't really help because a lot are held by pension funds. Plenty of cash deposits as far as the households are concerned--

MR. MORRIS. I think the answer is in the opposite direction of your assumption. We have been looking at total financial assets as a percentage of GNP and that ratio has declined from the 1960s and reached a bottom around 1978; it has been rising since then, although it's still below the level of the 1960s. But the percentage of financial assets comprised by checkable deposits and currency is lower now than it was in 1978, 1979.

VICE CHAIRMAN CORRIGAN. That's because of the stock market, though, isn't it?

MR. MORRIS. Yes, but the percentage of total financial assets held in deposit form has not been rising.

CHAIRMAN VOLCKER. You're including stock at market value.

MR. MORRIS. It has been shrinking.

VICE CHAIRMAN CORRIGAN. At market value. But it's not just the holding of the stock too. The point I am trying to get at is that the way that the public holds stock I would guess that much more of the household sector's holdings of stock equity is now through things like savings plan and pension plans. They are institutionalized as opposed to John Doe calling up his broker and saying that he wants to buy 50 shares of whatever. I assume that must be true.

CHAIRMAN VOLCKER. Well, all I know is that we should have started this discussion some months ago because at the next meeting we have a law which says that we have to set forth some monetary and credit aggregates and we have to decide which ones to set forth and--

MR. PARTEE. And what kind of a range.

CHAIRMAN VOLCKER. What kind of a range. I think Jim Kichline has the answer to all of these things because he put in an M1 consistent with the business outlook.

MR. MORRIS. That's why we have such a low growth rate for next year.

MR. AXILROD. Could I, Mr. Chairman, offer one hypothesis to your question of why the velocity of everything has declined, which it has. Velocity of M3, debt, and liquid assets all declined in the period since the early '80s. One thing you could think of is that in a deflationary period, financial assets become more "valuable" than physical assets, whereas in an inflationary period it's vice versa. And in addition to the outstanding amounts of financial assets going up, of course, you are evaluating stock at a [spurious] rate, so in terms of market values those prices are going up. Although it is an impressionistic view, it strikes me that there is something to that. There is just no hurry at the moment to dispose of paper and to get into physical tangible assets that are going to go up in value like a house or plant and equipment. That will eventually come. It explains all the velocities.

MR. PARTEE. What did you mean by that comment that it "will eventually come"?

MR. AXILROD. Well, when the interest rates go down and the stock prices go up to a point where it is cheaper to build the plant and equipment than it is to buy it, then it seems to me that we ought to begin getting the normal expansion. I didn't mean inflation; I meant a normal expansion in plant and equipment. It seems to me that you have to get that kind of "equilibrium." At the moment it seems to me much cheaper to buy a piece of plant and equipment--

CHAIRMAN VOLCKER. If you're right, I think you would have to get very low levels of plant and equipment and housing expenditures and I am not sure that they have been all that low.

MR. AXILROD. We do have a decent economy, but probably if what I said is right it's implying at some point [unintelligible] as prices go up to a point where it becomes economic, given the low level of inflation, to invest in physical assets--assuming inflation isn't going to revive.

CHAIRMAN VOLCKER. Mr. Morris. You already made your comments. [Mr. Boehne.]

MR. BOEHNE. As for the issue of 1986, it seems to me that we don't want ranges any narrower or any lower than we have had this year. And the ranges should be couched in the same way as was done in 1985: that we have to look at M1 in terms of M2 and M3 and those have to be evaluated against movements in velocity and the economy.

CHAIRMAN VOLCKER. Well, I have been assuming that. If we are not going to assume that, we better do a lot of work in a hurry. Governor Seger.

MS. SEGER. I just wanted to ask Steve a question about the likely moves by financial institution managers once the deregulation is completed. Would there be any chance at all that they would try to radically simplify their deposit structures? It has gotten pretty expensive to keep all of these different permutations and combinations of accounts. As I was sitting here listening to your explanation of some of these other changes, it occurred to me that there might be some rationale for simplification. I am old enough to remember when they had checking accounts and savings accounts and time accounts, period--not 17 varieties of other things. I just wondered if there might be some move in that direction.

MR. AXILROD. Well, we have tried to get a handle on that by surveys of what they intend to do and I think the results are rather diverse. There may be simplification; I wouldn't doubt that there would be some. But there seems to be a view that they are still going to try to pay relatively low rates to smaller accounts and then move more to market rates with larger accounts, which was the basis of some of our analysis. Maybe some will begin tying them to demand deposits. That has happened a lot more slowly than we would have expected some years ago, but maybe now this will develop more. Perhaps Dave could add a little more to that; I don't have any sense of it beyond that.

MR. LINDSEY. There is a little of that reported in the New York District--of tying demand accounts for households to savings and other accounts, such as MMDAs, so that minimum balance requirements are satisfied by the MMDAs and deposits in demand accounts can be minimized. I am not sure if that is simpler exactly, but it is a kind of change involving these different accounts.

MR. PARTEE. It would be an effort to capture a larger share of the business of the transactor.

MR. AXILROD. I have a vague feeling that a certain amount of complexity will tend to make people feel that they can maximize their profits a bit.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. Well, we did some of the same kind of work that Dave and Steve have reported on, with some different techniques. But not surprisingly, we came to about the same conclusion since the underlying data are the same. From the point of view of the targets--and this is a way of reiterating what has already been suggested--that suggests that given what appears to be a secular change in M1 velocity, we are going to need a higher M1 target for 1986; and because of the breakdown in the relationship with GNP it appears we are going to want a wider range at the same time. I would only add that maybe some serious thought should be given to giving somewhat greater weight to M2 in this configuration of aggregates--not because it is without problems, but just because at least for 1986 it looks as if we can avoid some of the problems created by shifts between M2 and M1 if we simply look at the broader aggregate and give it somewhat greater weight.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, I would think with regard to M1 that both this study and our own experience in 1982 and 1983 and 1985, coming so close together and being so much a function of the changing instruments, suggest that there is a learning curve that financial institution managers are going through as they learn how to price these things and be more au courant with the market. We don't know if we are trying to share our ignorance among ourselves. We don't know how consumers are learning to react, although Jerry had some very cogent things to say with regard to attitudes toward these various instruments. All that adds up to me to relegating M1 to a monitoring or information variable, without setting a range. I am hopeful that, as the Chairman has indicated, we would have a chance to review the work that has been done on various weighted M1 components or perhaps M2 components. We could have a justification for M1 being put on the shelf temporarily in that we are making a substantial effort to provide new data in the form of a weighted M1 or weighted M1s while it is on the shelf--that we are devoting resources to producing a better M1, if you will, just as we went from M1-A and M1-B and shift-adjusted M1 to today's M1 as basic underlying characteristics of the instruments changed. They have changed and the behavior of both the offeror and the user is changing. It seems to me that we could couple [a statement] that we don't have a target for M1 with [an indication] that we are producing new data--a new M1, if you will.

CHAIRMAN VOLCKER. Just in the interest of nomenclature, when we had M1 on a so-called monitoring status before, we had a range, didn't we?

SPEAKER(?). Yes.

CHAIRMAN VOLCKER. If I understood you correctly, you said we didn't.

MR. MARTIN. I said I would propose that we not have a range this time. I admit that, yes, we had a range before. But we didn't have as much uncertainty then as we have [now].

CHAIRMAN VOLCKER. I'm not talking about substance. When we called it monitoring before we had a range. You are going beyond that and don't even have a range.

MR. MARTIN. This time, yes sir.

MR. BOEHNE. Legally, do we have to have a range?

CHAIRMAN VOLCKER. Not for M1; legally we have to have some ranges. I think there might be a certain amount of disappointment--though maybe not so much after our recent experience. But a couple of years ago we wouldn't have gotten by without having an M1 range.

MR. PARTEE. I think the range ought to be 2 to 12 percent and [unintelligible] if it's any good.

CHAIRMAN VOLCKER. I remember a comparable experience in the past when we said it was premature to have ranges for the following year; I guess we said that for all of the ranges, didn't we? [Congress] kicked that back to us in about 2 seconds [and told us] the law says we have to have a range. Mr. Griffith.

MR. GRIFFITH. Mr. Chairman, I am going to pick up on Governor Seger's comments about simplification and maybe some mechanical problems that will make M1 worse. I think the reason that banks have not simplified is very simple: For the most part, most banks have little or no internal cost controls and don't know what [a deposit] costs them. I know for the West Coast [banks] I can say that. They have zero idea what it costs them to run a savings account. Those that have looked at it recently have come up with staggering numbers: I am talking about a hundred dollars a year to run a 5-1/2 percent savings account. If you take that number on a $5000 deposit and you went up to 5-1/2 percent on an MMDA rate, up to 5-1/2 percent you would be better off; it would be cheaper to offer a higher rate of interest and get rid of the overhead cost to run a savings account.

CHAIRMAN VOLCKER. Does that imply that it is cheaper to run an MMDA?

MR. GRIFFITH. It's cheaper to run any type of account than a passbook savings account by virtue of some of the anomalies--for example, sending out quarterly statements, the mailing costs, and the fact that some still require passbooks, etc. Yes, you can achieve some real economies of scale as far as trying to get one account that will enable you to have trailing balances. I'm saying 2 or 3 things for information. All I am suggesting is that the reason we haven't seen simplification is not because it won't occur, but when it does occur it will further complicate M1. It's simply because banks haven't figured out how much it costs them. But probably more important than that: In the 1980s banks, particularly the large banks --[unintelligible] the East Coast banks, the large money center banks in the West--have not had the earnings necessary to spend the dollars, the millions of dollars, for automation redesign. So I am just saying that I think this is going to occur and it's going to further complicate M1.

The only other comment I have has to do with the staff paper, which we in San Francisco enjoyed reading and thought was well done also. We take one exception, and we may be totally wrong, but would just point it out for Committee consideration. The staff here says that they believe that the large debit risk overdraft program will have little or no impact upon M1. That's on page 18 of the staff report. We have trouble with that. If you look at the total dollar amount of daylight overdrafts that are currently in existence, I in particular have trouble with a statement that it is not going to alter payments. Our analysis would indicate in our own District--in any event, the first four or five banks that we have looked at who are pretty good performers from the staff point of view--that overdrafts are really caused by international payments. Jerry could probably speak to this better than I, but the overdrafts are not caused by funding needs; they are primarily caused by the participation in CHIPS and things like that. And we say, yes, it will affect things in either one or two ways. Either somehow there will be fewer payments made per day or some alteration in the payments scheme of things or--what we think is much more likely and what we are hearing from our banks--there will be a real push, frankly, by the commercial banks to get their depositor to pony up overnight liquid dollars to hold down these payments.

CHAIRMAN VOLCKER. Are you saying that as it stands today or as we press on?

MR. GRIFFITH. As it stands today, I believe there will be some impact; as we press harder, and I am assuming pressing harder is sometime in later 1986, I think it is going to be significant. But also I think we have to take into consideration that as yet we have no formal data for those banks that will come in with, let's say, self assessments of not anyone being unsatisfactory and therefore are given zero caps. From the data we have there is going to be a considerable number of those across the country. You are talking about a significant degree of either a slower payment system or causing corporate customers to pony up the liquid dollars. I know it's early and we don't have the data; it's just intuitive. And I am not knocking the staff report; I'm saying this as just a warning signal--

CHAIRMAN VOLCKER. I've wondered about that too. Mrs. Horn.

MS. HORN. Mr. Chairman, I think that Pres' suggestion about a limited range for M1 has considerable merit. I think M1 is a very important number, as you know, and because of its transactions component may become very important to us again in the future, either in its current form or perhaps in a new form. But the transactions component makes it, I think, very special. And in one sense it seems to me that we discredit it by setting a range for it that we not only do not intend to bring it within but that we don't even think it will come in within. So I think we should consider the idea of not setting a range for M1 since the jury is really out on a lot of these matters.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. I am not really quite sure why I feel this way, Mr. Chairman, but I have a completely different point of view from the one that has just been expressed and that Press Martin expressed. I think it is really premature to give up on M1. I realize that monitoring is not really giving up on it and that M1 is a sick patient, to be sure; but I am not sure that it is ready to die. I think we ought to give it a little more time. Some of these portfolio shifts to which we are attributing the difficulty of M1 may slow down. According to the staff, and I have to agree with them, we apparently are not going to see the effects of further deregulation.

So, I think we ought to give it a little more time, and I would like to see us continue with a range for M1. But because of the difficulties that we have had with it, I think that the range needs to be wider than we traditionally have had. So for 1986 I would like a wider range perhaps at about the level that it is. The other thing that troubles me a little about putting M1 on a monitoring range is that I am not sure the markets are going to interpret that in the right way. I think they might very well feel that this is our way of abandoning further efforts against inflation.

CHAIRMAN VOLCKER. I think it is going to be a little hard to really abandon M1 just in terms of the law. It doesn't mention M1 but it talks about monetary ranges and nothing is more monetary in the public mind than M1. I think that we can deemphasize it--I'm just talking in terms of the law--all we want. Actually not presenting it is going to raise a little ruckus.

MR. RICE. I think we have to prepare the Congress and the public for that; we can't do it suddenly this time. If we think we are moving in that direction we need at least six months' preparation, and probably a little longer than that. The last time we set targets we seemed to [unintelligible].

CHAIRMAN VOLCKER. I don't think we ever set a target we didn't think we were going to meet. [We thought] M1 was going to slow down from this great burst in July; we didn't say it with great confidence.

MR. MARTIN. It says it again right here.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Given the results of M1 this year, I certainly think abandoning the range would have some appeal. But other than the legal aspect, it seems to me that there are public perception aspects that would be difficult. By saying that we are not going to establish a range and that we have a lot of work going on to try and get a better understanding of what has been going on gives me the impression that we have a bunch of engineers in the back room busily cranking away and at some early point we'll come up with an ideal model that might work. It might indeed work, but we would have to have a considerable period of time to feel comfortable with that. Clearly, in my mind, we're going through a period of considerable uncertainty. But given that, I would be inclined to use ranges as broad as possible, perhaps at least as broad as this year or maybe wider and certainly not narrower. I'd just put in the testimony a lot of judgmental comments as to how we are going to end up in those ranges as the year evolves.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, it seems to me that we are talking in terms of widening these ranges much more than they would have to be widened under any set of reasonable circumstances. For example, if we should say that 4 percent real growth next year is a reasonable target--and I think we would all be very pleased with that--if M1 [velocity] should resume its historical rate, 3 percent being the normal rate, then a 4 percent rate of growth in M1 would be enough.

In the past if we had no trend in velocity at all, if it was zero, then 7 percent growth in the money supply would be enough to finance that 7 percent rise in nominal GNP. So 4 to 7 percent would encompass a pretty broad range there.

MR. PARTEE. But velocity can drop.

MR. BLACK. Well, I was going to say: In the case you cited, Chuck, where you talked about 12 percent, that would imply an 8 percent drop in velocity--which might happen for a year--to give you a 4 percent rate of GNP.

CHAIRMAN VOLCKER. Or a 5 percent drop off.

MR. PARTEE. I got [the 12] by adding 5 + 7.

MR. BLACK. If you had a 2 percent--well, there's no use running through all this arithmetic. But 4 to 7 percent with zero percent [velocity growth], which seems about as low as you could possibly have it, is what I meant to say a while ago.

MR. MORRIS. How can we assume that zero has to be the floor?

MR. BLACK. I am not saying that it has to be; I am just saying that it seems like a reasonable floor. You can certainly go beyond that, but to go to 12 percent as Chuck suggested awhile ago, facetiously I think, implies an 8 percent drop if you have to--

MR. MORRIS. You could argue that the norm for M1 velocity is going to be negative.

MR. BLACK. It could be, but I don't know what the reason for that would be.

MR. MARTIN. Bob, the trouble I have with that is that the monetary policy assumption in the Greenbook carries a 125 to 150 basis point decline in interest rates next year. That means you're throwing in another big variable, the same big variable again--a big drop in interest rates.

MR. PARTEE. NOW accounts could get pretty popular.

MR. BLACK. It's anybody's guess as to what those rates are going to be.

MR. MARTIN. All I'm saying is that that is one of our assumptions.

MR. BLACK. Pres, they are also talking about a much lower rate of growth in real GNP than the 4 percent I said might be reasonable. I am just saying that you can get 4 percent real growth with comparatively little M1 unless it really is misbehaving, which it may be.

CHAIRMAN VOLCKER. We have a problem here. When I listen to this conversation we have a law that says "monetary and credit aggregates." The only credit aggregate that we have is as far off as M1.

VICE CHAIRMAN CORRIGAN. That's the problem I have. I think one can make a case that all of these aggregates are way off.

MR. PARTEE. That is the thing, Paul. The public seems to buy the concept that credit growth could be as much as 12 percent a year. I think that we have had around 12 percent, the top end of the range, for each year at a time when obviously nominal GNP has been much less than 12 percent. And infinitely extended that would mean an infinite debt burden. But nobody seems to comment about that rapid growth in credit; they seem to accept that.

CHAIRMAN VOLCKER. Nobody knows what to do about it. The implication is to tighten up, but nobody wants to tighten up.

MS. SEGER. Mr. Annunzio said to cut up your credit cards.

MR. PARTEE. Should have done it a year ago!

CHAIRMAN VOLCKER. It still intrigues me that the previous incident we had of debt rising so fast relative to GNP was in 1928-29. I've been assuming that we would have targets of more or less the traditional type with a lot of [explanatory] language, maybe put M1 on a monitoring basis the way we did before, with a target. That is clearly within the scope of what we can do. The same thing is true for credit; that could be a monitoring--

VICE CHAIRMAN CORRIGAN. I'd use them all. We've got to play one against the other. I think if we scrap one or two of them we would really have a problem. At least if we keep the traditional framework, with perhaps a variation on a definition of a monitoring range, I think we are in a better position. If we scrap one or two of them, I think we could get into a terrible box.

MR. BLACK. At a minimum, we can use these sometimes to justify what we want to do.

VICE CHAIRMAN CORRIGAN. That's what I have in mind.

MR. BOYKIN. Mr. Chairman, you mentioned that no one wanted to tighten.

CHAIRMAN VOLCKER. I meant the general public.

MR. BOYKIN. I think that is true. But the thought strikes me--you referred to 1928-29--and I just wondered if we're not rationalizing ourselves into an even more difficult situation.

CHAIRMAN VOLCKER. We may be. That's the problem. Ex post, after 1928-29 [it's clear] that the Federal Reserve should have been tighter.

MR. BOYKIN. The practical problem in terms of ranges and so forth is what several others, including Gary Stern, have said. To do a complete change to me would throw even more uncertainty into a very uncertain environment.

CHAIRMAN VOLCKER. Just by instinct, I don't think we are prepared to throw out much of this without at least a very careful consideration of replacing [what we throw out] with something else. Outside these ranges we could say, well, we're going to stabilize exchange rates or move interest rates or commodity prices.

MR. BOYKIN. At midyear we tried to make some adjustment in recognition of what has actually happened--rebasing, widening the ranges. It is true that the behavior of M1 has not improved, but it seems to me that keeping the M1 range--downgrading it through words or monitoring it or whatever you want to call it--and widening the range some would be the only prudent thing to do right now, until some of this other work could be done and we know a lot more than we do [now]. I don't think I could say with any assurance that things might not return over the next six or eight months.

CHAIRMAN VOLCKER. I am tempted to ask--it is so late in the afternoon I won't press for an answer--what you may want if you have targets and you can't have monetary and credit aggregates in the sense in which it is called for by law. What would you use a year ahead, midyear, 18 months ahead?

MR. MARTIN. M2 and M3 and monitor M1 and nonfinancial debt.

CHAIRMAN VOLCKER. I'm throwing out those things.

MR. MARTIN. Oh, I see.

MS. SEGER. There was a conference just held that would suggest the price of gold.

CHAIRMAN VOLCKER. Are you prepared to suggest that?

MS. SEGER. No, I didn't say that. I just said that there was a conference just held that would suggest the price of gold.

CHAIRMAN VOLCKER. There are those who would say that; it is a small but hardy band.

MR. PARTEE. Commodity price people are close to the gold people.

CHAIRMAN VOLCKER. Take a basket of commodity prices; stabilize the general accounts.

MR. MARTIN. Talk about missing [a target]!

MR. BLACK. If you choose prices, you still have to have some mechanism that you play around with to do that. You have to have some tool or handle.

MR. MARTIN. Interest rates or exchange rates. What other alternative do we have?

MR. BLACK. That or some aggregate. Exchange rates, interest rates or aggregates, or some combination. I think that is exhaustive.

MS. SEGER. What would happen if we were to publish the monetary aggregates less often?

MR. BLACK. We'd be accused of withholding useful information.

MR. RICE. The more you ask us to focus on this, the more apparent it becomes that we should be hesitant about moving away from the aggregates too quickly. The alternatives seem unsatisfactory.

CHAIRMAN VOLCKER. I don't hear anybody arguing. It's practically impossible in the time that we have--without creating a revolution--to move away from some combination of these aggregates, as bad as they are.

VICE CHAIRMAN CORRIGAN. It seems to me that what we really need to do in the short run is to lean a little further in Governor Partee's direction of nominal GNP.

MR. PARTEE. Well, of course, the same complaint can be made of nominal GNP that Bob made about prices. How do you get there? It used to be that you could get nominal GNP by changing interest rates.

VICE CHAIRMAN CORRIGAN. I am just saying that in the context of having aggregates in more or less traditional form you just make more general noises about looking through the aggregates at the GNP.

CHAIRMAN VOLCKER. You may be promising more than you can deliver.

VICE CHAIRMAN CORRIGAN. I'm just grasping for straws.

CHAIRMAN VOLCKER. You may put the straw on the camel's back, if you keep grasping!

MR. PARTEE. How about a range for GNP?

CHAIRMAN VOLCKER. I'm not hearing great inspiration. I think we ought to adjourn for the day.

[Meeting recessed]

December 17, 1985--Morning Session

MR. KICHLINE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Would you repeat or amplify what you said about energy prices?

MR. KICHLINE. They have risen in the last couple of months, but for all of 1986 we are forecasting essentially flat energy prices.

CHAIRMAN VOLCKER. You're not assuming a big decline in oil prices?

MR. KICHLINE. Well, I was referring to energy prices more broadly. We have a decline of about $2 in the imported value of oil. But there are also service fuels, natural gas, electricity, gasoline, home heating fuel, etc. For the whole ball of wax, we essentially have flat or a couple of tenths higher in 1986.

CHAIRMAN VOLCKER. Comments?

MS. HORN. Jim, if one is looking at the net export sector for a kick upward in the economy next year and is worried that that might not happen until the second half, let's say, what more specifically are the outlooks for some of the economies abroad--the developed countries. We're beginning to hear some good news on that.

MR. KICHLINE. Why don't I let Ted answer that question.

MR. TRUMAN. Contrary to the good news you hear, our outlook for the industrial countries as a group in 1986 is that [growth] will be on average the same as it has been this year. Western Europe may be a bit stronger; I assume the stories you particularly are referring to have come out of Germany on this score. But Japan is expected to be substantially weaker, and we ship much more to Japan than we do to Germany. So, on balance, we're looking for something in the 2-1/2 to 3 percent growth, fourth quarter over fourth quarter, for these countries, which is about what we think they had in 1985. It is, as this year, somewhat faster than the growth in the United States. And in that sense, it is redressing the balance of the previous three years when we were growing faster than they were. But we don't think we're getting any substantial additional stimulus from that source. Our forecast for the German economy itself is at the upper end of the range of the forecasts that one finds coming out of Germany--3 percent year over year and 2-1/2 percent fourth quarter over fourth quarter. I think it's the other way around, [2-1/2] percent year over year and 3 percent fourth quarter over fourth quarter. That is basically at the upper end of the range of the German official and private forecasts.

MR. MELZER. What about the tax bill, Jim? If that were passed, what impact do you think that would have? And have you taken anything into account for that?

MR. KICHLINE. We haven't taken anything explicit into account. The way it stands now is that if it were passed, it clearly would raise the cost of capital with respect to the business sector--especially for equipment, given that all the proposals get rid of the investment tax credit and change depreciation schedules as well as corporate income taxes. It's less clear that it would have as large an effect on nonresidential structures. But for the equipment side we think it would be a negative. One of the problems we have is that, given the uncertainty over what's going on in tax reform, a case can be made that in some areas businesses are just holding off and waiting. So it may be having somewhat of a depressing effect now in business planning. And it's unclear whether we're going to get another slug when something really comes along. In financial markets, clearly, one of the areas where tax reform is having a role is in the municipal market where we're having this surge of offerings that may be cut off if tax reform is passed. But we think the major effect as it now stands would be in the business sector.

MR. MARTIN. Jim, what's your impression of the George Gilder argument that the lower top bracket rates in one or another version of the tax revision would actually stimulate the entrepreneurs--the proprietorships, the smaller firms, the Silicon valley types and the Boston railroad people and what not? [He argues] that all the fuss in the Halls of Congress is coming from General Electric and people like that and that actually this might have a positive effect on business fixed investment coming from a different source. Is that--

MR. KICHLINE. Well, I think it's possible. The smaller firms of the type you are talking of, especially in some of the service sectors, often are not that capital intensive, and such firms really are not affected in a major way. Perhaps the corporate income tax rates play a more significant role. I don't know how to sort that out. I think that is probably a longer-term kind of argument and the issues on tax reform as they would affect major capital expenditures probably are shorter-term kinds of arguments.

MR. PRELL. Governor Martin, I might mention that venture capitalists in various paper surveys have indicated that the relatively low capital gains rates are very important to them. With these tax reform proposals, the capital gains taxes would not be as relatively low as they are now, so that some shift--according to these views--might be in store in terms of that kind of entrepreneurship.

MR. FORRESTAL. Jim, on the face of it I would have thought that the lower interest rates that you're projecting would have given more stimulus to the economy than you have. I take it from what you said that you're seeing an offset in the Gramm-Rudman Bill. But aren't there government spending plans in the pipeline that are going to carry through to the first quarter and perhaps into the second quarter? The second thing I'd like to have you comment on, if you would--if you said it, I didn't hear--is the effect of inventory investment on the economy.

MR. KICHLINE. Okay. With respect to inventories, we have inventories as essentially a neutral force in 1986--basically running close to final sales. Our perception was that inventories currently probably are about in line and that businesses would tend to add to their stocks only as sales rose. So, the change in inventories is basically not very much. Certainly, it wouldn't be affecting 1986 as a whole. As I noted in my briefing, there are some questions currently--that is, in the fourth quarter--as to what's going on; we may be seeing somewhat larger accumulation than we have forecast, which would tend to give us somewhat stronger growth.

With respect to the federal purchases, you're quite correct. There is a lot of spending in the pipeline. That's one of the reasons why--in putting this together and looking at Gramm-Rudman and saying that something happens March 1 to the tune of about $12 billion--we see lots of offsets and lots of slippage in various programs, both defense and nondefense, so that our net cut is about $5 billion. In addition, some of these financial transactions don't really show up in the GNP accounts as cuts. They wouldn't be cutbacks in federal purchases as such, so some of the cuts will not appear in the GNP accounts. It's very hard for us to parse out in our minds precisely what happens between cuts and how much is a reaction in some other sectors to interest rates changing. But on balance, we took something out as a result of the Gramm-Rudman package [and put in] a little more consumption in housing and a shade more in business investment as a result of lower interest rates. But the net effect boils down to, roughly, a couple billion dollars out of 1986 because of that, and that amounts to roughly 3 or 4 tenths [on GNP]. It's not a big net effect. But the issues, it seems to me, are very important--especially as you look forward to the summer of 1986 when this major problem surfaces for fiscal year 1987. And we have not assumed that come October 1, things just come to a halt. Rather, we have continued sort of along the path of having mild further cuts late in 1986.

MR. FORRESTAL. If we didn't have Gramm-Rudman--if it were declared unconstitutional--would your forecast be where it was before or would you see greater strength than your previous forecast?

MR. KICHLINE. I think it would have been about where it was. Since the meeting in November I don't think that things have changed in a way that would have induced us to have made major changes. Interest rates have come down, especially in the long markets, more than we had thought. But, sorting through some of the other sectors, I would read them as about the same or maybe a shade weaker. So, I would say we took something out of the forecast for Gramm-Rudman. I would have had a higher number if we didn't have Gramm-Rudman.

MR. PARTEE. But the main thing, Jim, that has happened since the last meeting is the increase in financial asset values, which is pretty big.

MR. KICHLINE. Right.

MR. PARTEE. You would include that in the forecast as a positive element but with a considerably muted weight, is that right?

MR. KICHLINE. The quarterly model now would say that, given the increase in asset values in 1985, there is a lag in the impact on spending, which appears over 4 to 6 quarters. We have had something like equity prices raising market values by $350 billion or so in 1985. But that would add about a quarter of a percentage point to personal consumption spending in 1986. So it's a limited effect.

MR. PARTEE. A quarter of a percent?

MR. KICHLINE. Well, keep in mind that a lot of those values show up in pensions.

MR. PARTEE. Yes, I know that a lot of them are not possessed directly by households; they're in pensions and--

MR. PRELL. Even indirectly, to the extent that corporations can recapture some of that. So it's a murky area.

MR. STERN. In a way, though, given Gramm-Rudman the way you have it in here and given OPEC and oil prices, I'm surprised there isn't a bigger change in the inflation forecast--that it would have slower growth. It seems to me we've had some positive developments in commodity markets generally and so forth.

MR. TRUMAN. On the oil price side, the OPEC announcement came sufficiently late that we did not change the forecast that we had before. So this $2 a barrel, roughly, further decline in the price of oil is basically predicated on the assumption that the pressure that is built on supply is coming from non-OPEC sources. It assumes, and there is a lot if uncertainty in this area, that OPEC will be trying to produce essentially in '86 what they produced this year in oil terms--16 million barrels a day. It's a little uncertain what they mean by fair market share in this context. If, contrary to that assumption, we had them trying to produce more, then we would have more oil price decline than we had built in. Because of the timing as well the uncertainty we haven't put in an additional oil-price decline because of an interpretation of what OPEC did.

MR. KICHLINE. On the risk side, I didn't mention that, but I think it is important. There are some arguments that this market may well collapse by next spring. Some of the work we've done suggests that if you took, say, $5 off the price of oil and got closer to $20 a barrel, that's worth about 1/2 percent on the GNP deflator and adds almost the same amount to real growth. So it is a major factor.

MR. GUFFEY. What kind of impact would that have on our trading partners--Germany and Japan, for example? Would that--

MR. TRUMAN. On average, for the industrial countries you get about the same impact. You'd have maybe a bit more positive impact from Japan and Germany, but you'd have an offset in Canada and the UK and those countries that are oil producers. So, on average, you would get about the same order of magnitude in those countries as a group as you get in the United States with a $4 to $5 dollar [per barrel] cut.

MR. PARTEE. Jim, I understand there's going to be quite a full-scale revision on the GNP around the end of the year or early next year.

MR. KICHLINE. Friday morning.

MR. PARTEE. So, we're in fact going to be dealing with different numbers next year. Now, that includes a rebasing that changes relative weights, doesn't it? My question to you would be, since it will be an issue, I believe: What kind of hazard would the changes in weights and all that goes with rebasing present for the Committee in making a projection?

MR. KICHLINE. Well, this is going to be a massive revision. As you know, in many of these numbers significant changes will be made from 1959 to date. There are some definitional changes and they've discovered an error they've been making for the last 5 years that influences something. These numbers will come out Friday. I think one of the areas that is important is the fact that on the oil price side, when you rebase to 1982 oil gets a much lower weight. It has much lower prices and a much lower weight. If you want to say these numbers would give you a deflationary impact, as of Friday they will give you a smaller deflationary impact when you rebase. So, there will be lots of things happening.

MR. PARTEE. It gives oil a lower weight?

MR. KICHLINE. It will have a lower weight based on 1982 dollars.

MR. PARTEE. Because the physical flow of oil has not done as much as other things?

MR. KICHLINE. Right.

MR. PARTEE. I see. So you get less deflation because it is based on '82 than you would by remaining with '72. Somebody told me that they thought it was going to moderate the growth rate throughout the period for some technical reason.

MR. KICHLINE. I don't know.

MR. MORRIS. One reason, as I understand it, is that they had been assuming that the price of computers has not changed over this period. And they're substituting an assumption of a 10 percent per year decline.

MR. PARTEE. You'd think that would raise the growth rate.

MR. MORRIS. It's going to raise the growth rate [unintelligible]. And that's fairly significant.

MR. PARTEE. But my understanding is that the whole effect would be a moderated growth rate.

MR. STERN. There are a number of other changes beyond that computer [change].

MR. MORRIS. What factors would moderate that?

MR. PARTEE. I don't know. I understand that it has to do with the rebasing, fundamentally.

MR. KICHLINE. Yes, it is the rebasing. There are two things going on here. In the computer case it's not just that they are trying to get an appropriate price index where they have arbitrarily held the price since 1982 to date at 100, but that they are going to rebase from 1972 to 1982 and that effect will run in the other direction. So it's not clear to us at this moment how large an impact it will be. But you're quite correct; if you didn't rebase you'd have a substantial increase. There are other things going on, on the income side in particular, where they have tried to account for some underreporting of income. It's questionable at this point as to what impact that might have on the saving rate and other things. But certainly from what they have already published, in 1977 the saving rate is up about a percentage point from the now-reported numbers. In any event, the world will be remade on the 23rd and will bear little relationship to what we're [seeing] now.

SPEAKER(?). The 20th.

CHAIRMAN VOLCKER. Fortunately, we only have to look ahead instead of back.

MR. MORRIS. Except, unfortunately, we don't know where we are.

CHAIRMAN VOLCKER. Does anyone want to comment on where we are and where we're going?

MR. MORRIS. I think events since the Group of 10 meeting have been amazingly good in the sense that we have had a pretty sharp decline in the dollar and that has been accompanied by a decline in long-term interest rates. And that is the combination that must be desired and I must say it's a little surprising. It seems to me that we're still rather vulnerable, despite this, to any loss of confidence on the part of the foreign investors in the United States. I think it's quite impressive that, despite the size of the decline in the dollar, I haven't been able to detect any nervousness on the part of foreign investors in the United States. And that is a big plus for us. But I think we still have to be alert to the possibility that that kind of thinking could change.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I don't know where we are and I don't know where we are going, but it didn't stop me from talking before so I don't expect it to stop me this time! I think Jim and his group have done a usually good job in dealing with a very difficult period. Their position is certainly plausible, particularly when you consider Gramm-Rudman, but I think it's a little more likely that with the kind of decline we've had in long rates, particularly mortgage rates, the surge in stock prices that Chuck mentioned awhile ago, the decline in the dollar, the substantial recent growth in money and liquidity, and the prospects of further declines in oil prices, that the errors will be on the high side of their forecast rather than on the low side. I just have to conclude that the economy has to respond at some time--I would think in the not too distant future--to this convergence of favorable factors. I don't have any great confidence in that view, but that's my best guess.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. In terms of the Midwest perspective, our feelings both currently and prospectively are very much unchanged from the previous meetings. As we look ahead we think the expansion will continue, albeit modestly and certainly unevenly. Therefore, our outlook is certainly consistent with the staff's forecast. Indeed, perhaps there is an opportunity for somewhat improved results next year as opposed to what the staff is suggesting, as the risk of coming in weaker is diminishing, I think.

I have a couple of specific comments. I almost hate to mention it, but the agricultural situation does continue out there. And I think the situation is, if anything, more serious. The crop harvest is about completed, on normal schedule, but the production is going to be very significantly higher than last year. That will continue to put pressure on commodity prices, and I think we're in a period in which production loans are going to have to be paid off. It will be interesting to see how the production values come in relative to the loans. There is also, of course, the issue of land values; the rate of decline certainly is diminishing but values are down very substantially whereas the debt has not come down. So we have this very difficult gap between debt and land values, which has to be dealt with. As a consequence of all this, I think the stress on the agricultural banks is continuing in a very significant way. Their charge-offs this year are going to be substantially higher than was the case last year. A very significant number of them are going to show losses this year as compared to last year. So the agricultural problem continues to be very important.

My second comment is on the tax bill. I must say that the people I talk with say this continual uncertainty is extremely difficult from a planning perspective. They just are having an awfully tough time figuring out what to do. There are a lot of people who say cynically that a bad bill would be better than this continuing uncertainty that they are dealing with. Also, as kind of an editorial comment: Those in the manufacturing sector do feel that the bill as it has been proposed by the House is, at least from their point of view, a very bad bill.

I think the most significant change that I've seen over the last few weeks is related to this exchange value of the dollar. The attitudinal change that I sense out there is just very important. No one will say they got this deal or that deal because the value of the dollar is down; but everybody says it just is a much better environment in which to at least negotiate. They'd like more. In terms of the yen, they would like 180 or 190. But most importantly, they are pleased with what has been accomplished and are very hopeful that the rate will not go back up. The whole change of attitude based on this I find very, very positive.

CHAIRMAN VOLCKER. On this farm situation, I don't know whether you or anybody else had any comments, but we've had quite an increase in agricultural prices from a very low level in the last month or two months. Does that make anybody feel any better?

MESSRS. KEEHN & GUFFEY. No.

MR. KEEHN. The bankers are getting very afraid out there. Attitudes and emotions, particularly in Iowa, are getting very, very frayed. There have been some bad incidents. I don't think that is necessarily symptomatic of the economic circumstances, but I don't sense any improvement at all.

CHAIRMAN VOLCKER. I wasn't thinking of the bankers so much as whether anybody has any more hope for--

MR. STERN. Well, if you're in the livestock business, I think attitudes really have improved. If you are in grain and barley or corn and so forth, that's a different matter. Livestock people are much more optimistic. Jerry knows: Our livestock people are optimistic almost all of the time.

MR. MARTIN. They wouldn't be in the business.

MR. PARTEE. Well, the price changes mainly have been in livestock.

CHAIRMAN VOLCKER. It has been by far the sharpest, indeed; but it's also significant in corn and wheat, though from a very low level.

MR. KEEHN. Still, comparatively, it's awfully low as you go back the last few years.

CHAIRMAN VOLCKER. There is no question that they are lower in the longer-term perspective. Governor Martin.

MR. MARTIN. Mr. Chairman, it seems to me that as we enter the fourth year, if that's what it is--if anyone can measure the beginnings and ends of these expansions--the risk elements continue to build. The Chairman mentioned agriculture. There is some miracle kind of farm bill, which looks like it has made some progress, that begins to change the game a little--and perhaps in a positive direction--with regard to world prices and targets and other prices from the U.S. government. That bill would require a bit of change of format by agricultural producers and traders in the commodity markets, if it passes in that way. I think that's characteristic of the export area on which we are depending for late-in-the-year support for the economy. What's different about that to me is the much more assertive --I won't say aggressive--stance and approach taken by Clayton Yeider and by this administration. I am not criticizing that approach but it complicates the [effort to] increase U.S. exports in that there are [potential] retaliatory actions in Europe and elsewhere. I haven't seen anything that really clearly lays out how in this assertive, almost adversarial, atmosphere we get that additional export help in the GNP sense. Probably we will, but it seems to me that there is a risk when you approach these negotiations in a somewhat different way.

As far as housing is concerned, I am usually the pessimist in that area. I think the staff forecast in the housing area is reasonable at this time, but it is reasonable because of the monetary policy assumptions. A decrease of 125 to 150 basis points in rates is really necessary if we are to get this more or less modest improvement. There is a down side in this too, of course, in that as the regulators put pressure on the originators and servicers of mortgages, there is a risk that this plus in the GNP won't come about because the credit standards will be higher, because they won't be able to qualify the borrowers, and because there have to be more write-offs. They are getting to this talk about good banks and bad banks and splitting the mortgage originators into the good institutions and the bad institutions. Well, that's another factor to cope with, another bit of uncertainty. Uncertainty means risks in that area. The risk of a collapse in non-residential spending is obvious. We have gone over practically every molecule of that risk in our meetings here, and rightly so. There is a slight decrease, 0.7 percent or something like that, in the model results here. And I understand that. Jim warned me that he built some other slow growth rates in there before and the markets raced on ahead. But there is a risk, isn't there, of a collapse--of a really sharp negative in that area? One could go on to examine the risks in the financial institutions; 113 banks have changed the name on the door. In most cases, it's not a calamity, but the risk goes on. And banks really haven't addressed the write-downs that they are going to have to do with the Perus of the world, have they? Some have started, but relative to banks in other countries and relative to so-called tax reform, now characterized as a revision treatment of the bad debt reserves, that certainly is a risk--in terms of facing that question and in terms of bank credit growth (not off-balance-sheet but on-balance-sheet bank credit growth) and the funding of continued economic growth. We are only talking about another four quarters of around 2 percent. We certainly have had enough quarters of around 2 percent with the downside risk what it is. So what I want to stress this morning is the need to keep in mind the monetary policy assumptions in this projection. I support the projection but I also support the monetary policy assumptions, which go to a rather prompt--I almost said a bad word--a rather prompt accommodational posture and carrying that on out for the balance of the year.

MR. PARTEE. Prompt accommodational?

MR. MARTIN. Yes, I didn't want to say ease.

CHAIRMAN VOLCKER. [Unintelligible] 4 to 7 percent projection in the long-term M1.

MR. MARTIN. Well, I think that projection for M1 may be a little on the low side, Mr. Chairman, and given the interest rate--

CHAIRMAN VOLCKER. You like part of the monetary policy assumptions.

MR. MARTIN. I just noted that we get a 7-5/8 percent funds rate pretty quickly and that it's at 6-1/2 percent by the end of the year. It seems to me that's a vital part of making 2 percent growth next year with all the downside risk.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, it appears to me that we are depending on the modest growth in employment, some pickup in housing, and favorable consumer attitudes to get us to a moderate 2 percent rate of growth over 1986. If we look at the uncertainties in the forecast, particularly the uncertainties with regard to consumer capacities to continue spending, and if we also take account of our expectations that there will be some movement toward fiscal restraint, it seems to me that the risks to the forecast are on the down side. Now, obviously, some very good things have happened. In very general terms, interest rates have come down and the dollar has come down. But when you try to evaluate what the impact of these generally favorable developments would be on specific sectors, it's very hard to see how this is going to get us more growth than is forecast for 1986. So, far from seeing the risks on the up side as Bob does, I see them rather on the down side. So to me, the main question that is raised is whether a moderate 2 percent rate of growth for 1986 is acceptable, all things considered, in the current circumstances, particularly in light of the inflation outlook.

CHAIRMAN VOLCKER. Which is what?

MR. RICE. Well, it's less than 4 percent. That's the outlook, and it could be [less]. Most of the considerations surrounding that would suggest that, if anything, it would be more likely to be lower rather than higher. There are oil price possibilities. So, I would say that the inflation outlook is rather more favorable than unfavorable.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, form the perspective of the Sixth District, things are looking considerably better than they did a month ago. We have had a very sharp decline in unemployment--from a little over 8 percent to about 7.3 percent--and even the employment in manufacturing, textiles, and apparel has tended to stabilize. The textile and apparel people, as well as some manufacturers, even have seen some increases in their orders over the last month. This is not reducing the protectionist sentiment, I might say. They are not really attributing this [improvement] to a fall in the dollar, although they recognize that there might be some of that. But they are still looking for protectionist measures like the Jenkins bill to make some fundamental changes in their situation. Construction continues to be very good in most areas. To be sure, we have weak spots in the District, such as Louisiana, but construction in most states is doing pretty well. Retail sales have been very, very good, particularly in the post-Thanksgiving period. And from an impressionistic point of view the business people that I talked to really are exhibiting a good deal of confidence about 1986. They think that growth is going to be not marvelous, but fairly moderate, and perhaps a little better than in 1985. People I talked to, like those Si Keehn mentioned, are very discouraged about the tax bill. They would like it either to be passed or to be taken off the table so that they can make their plans. If the bill is revived, as perhaps it might be, that is going to cause additional uncertainty, and I think that business people might very well defer some business decisions in 1986, which might be a negative for the economy.

So, extrapolating from that kind of local experience, it would seem to me that maybe the risk is slightly on the up side. I would think that the effect of interest rates would perhaps be more of a stimulus to the economy, notwithstanding Gramm-Rudman, than in the Board staff's forecast. So I continue to look for a little stronger economy, perhaps somewhere in the area of 2-1/2 to 3 percent for GNP. I guess the difference between my forecast and the Board staff's forecast is not so much in the numbers. Rather, it's in my feeling that I can accept the 2-1/2 to 3 percent growth rate, while the Board staff's forecast would be unacceptable. If they're right, I think that perhaps the time has come to make some move to bring that up a little. But again, I believe we are probably going to see 2-1/2 to 3 percent growth.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, the economy in Texas and in the Eleventh District has continued to grow at a sluggish pace. That's due in large part to a further deterioration in the energy sector. For example, the rig count is at its lowest level in ten years. The District's construction activity in 1985 has shown more rapid growth than that for the nation as a whole, but that relationship is expected to flip-flop in the year ahead. Even the growth of the service sector is like that of the nation, and no turnaround is in sight. Both the economy and the economic mood have continued to deteriorate, and I am hard pressed to find any sources of potential optimism. In short, the District's economic problems are pervasive and extend far beyond those attributable to the energy sector.

Having said that about the Eleventh District, our view of the economy as a whole for next year is that we would anticipate probably a little better year than we had in 1985. Our GNP number probably would be closer to 3 percent than to 2 percent.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Just looking at forecasts--for what they are worth, which is probably not a lot--our forecast for 1986 is one that has GNP in real terms growing at about 3 percent or a shade more. In that sense, it looks more like the consensus of private forecasts than it does the Board staff's forecast. There is another important difference in that our forecast basically assumes that short-term interest rates are unchanged from roughly where they are today rather than having a decline already built in. But like Governor Rice, I don't have a lot of conviction about that forecast because when you go through sector by sector it's hard to find concrete evidence that would suggest that there is any real marginal growth on the up side, and there are the risks on the down side. We are at a point, in my judgment, where we have 3 or 4 very, very major factors that transcend the sectors. I am not sure anybody has really digested these factors, and I am not sure one can. One is the decline we have seen in the foreign exchange rate itself. I think we had some surprises on the up side of that phenomenon and I think one could argue that we may get more bang out of that than is being allowed for in the conventional kind of forecast. Just as one example: If the so-called Baker plan works as designed, that in itself could end up financing a very [robust] increase in import growth in the developing countries and Latin America, and we would be presumably the major beneficiaries of it. But leaving aside that particular aspect of it, I think that one at least has to allow for the possibility that we may get a little more help there than we are counting on.

The second area that seems to me to transcend individual sectors is this recent run-up in stock and bond prices. I can make a case that if those gains are roughly sustainable, they could very easily provide more of a kick to the economy than the quarter point that Jim mentioned, particularly when you recognize how late in this year a major part of that gain, particularly in the stock market, has occurred. Of course, the big question is sustainability. I think one could argue that there is some danger, especially in the stock market, that it already has overshot the mark in some fundamental sense, in which case what looks like it could be a plus for the economy right now could turn out to be a minus. I also think that there is at least a good chance that we do not really know how to build the oil price, and more generally commodity prices, into an economic forecast--especially the oil price implications. We don't know what will happen to the oil price. That too strikes me as a variable that could have a larger effect than is being allowed for now, simply because nobody has a way to take account of it. I think the fiscal situation now presents some real uncertainties: the combination of Gramm-Rudman, whatever it turns out to be, and the tax bill. Again, if you look at them in a rather conventional way, I think one is powerfully drawn to the conclusion that if they play out as scheduled, their effects on the economy--at least in the timeframe of 1986-1987--are going to be to reduce growth, net, and possibly even to increase prices a little. But, again, I don't think we know enough about what in fact will happen; we certainly don't have a good fix on the kinds of anticipatory behavior, both in the market and in spending decisions, that have already been built into the equations so to speak.

And finally, there is this whole money and credit problem that we talked about yesterday. As I mentioned yesterday, when you make what seem to me to be some reasonable assumptions about definitions and so on, I think you have to come to the conclusion that money and credit, however defined, have been growing very, very rapidly--whether you look at that in terms of debt accumulation or any way you slice it up. Now what does that mean? As a number of people, including myself, suggested yesterday, you can argue that velocity trends have changed. Nevertheless, even if you make that argument, that phenomenon still sits there and it has to be something of a concern. So, back to the question of a forecast: As I said, ours is 3 percent or so; but I don't think we can quite capture the dynamics of this situation we face simply by looking sector by sector, because I think these four of five things I have mentioned transcend that. And it's not clear to me how they're going to play out.

MR. MARTIN. Just a factual question, Jim. Is DRI still sticking to a 1.9 projection of GNP for next year?

MR. KICHLINE. I think that's the latest.

MR. PRELL. Yes.

MR. RICE. Jerry, do you expect the Baker initiative to have an important impact before the end of 1986?

VICE CHAIRMAN CORRIGAN. I think that's asking a lot. As I said, we have gone through the numbers and if everything panned out reasonably well over the three-year period as a whole, it could support a very, very robust increase in imports.

MR. RICE. I would agree with that. I just wouldn't expect to feel the impact before the end of 1986.

VICE CHAIRMAN CORRIGAN. We won't get that much, but we could get some. And when you take into account Mr. Keehn's comments about some of the anecdotal responses he picked up in terms of changes in the foreign exchange rate, there may be a little more there. I'm not projecting a humongous swing in the trade account in the first quarter, but there could be a little more there than the conventional wisdom is allowing for.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to the staff's forecast, it has been fairly well detailed that there is uncertainty on either side that could affect that forecast, and as a result the forecast seems to be quite reasonable. The news from the Tenth District is [no] better than it has been before. Indeed, the outlook is dominated by the problems in agriculture and energy and the now-surfacing real estate problems that are fairly well known in Denver, Oklahoma City, and some of the other larger metropolitan areas. If you talk to individuals in the various areas, you will find mixed comments if they are not dominated by the agricultural and energy [industries]. If they are in the urban areas, they think things are going very well. But overall, I think the attitude is more negative than positive. There is great uncertainty about the retail sales in the Christmas season, simply because we have had very cold weather that started right at the Thanksgiving holiday and it's uncertain whether or not there is enough time left to have good Christmas sales.

Having in mind that the staff forecast may be as good as any other, and looking ahead to 1986--with 2 percent growth, a fairly high unemployment rate of 7.3 percent at year-end, inflation being down or in check if you will, and the hope that it will be even less than the forecast because there are no decreases in energy prices built into that forecast, as I understand it, and with capacity utilization projected to be at fairly low levels--I think it would be unacceptable in even the fourth year of recovery that we should be concerned about an upside risk, frankly. I would like to see something greater than 2 percent; something in the 3 to 4 percent range would be quite acceptable. And to the extent that monetary policy has a part to play, particularly against the background of some, albeit imperfect, deficit reduction package out of Gramm-Rudman, I think we ought to be on the side of doing what we can do; and that in my view is to bring about somewhat lower interest rates fairly quickly.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, I think the Philadelphia District is a stronger area--particularly in New Jersey, Delaware and the Philadelphia part of Pennsylvania--than many other parts of the country. There are still many depressed areas in other parts of Pennsylvania, but I think the District generally is doing better than the rest of the country.

As far as the national economy is concerned, we are talking about roughly 2-1/2 percent real growth, give or take a little, and I think that's a reasonable forecast. One can make a case that it will be somewhat stronger or somewhat weaker depending on the dynamics that take place. But I ask myself this question: Is 2-1/2 percent satisfactory? I don't think 2-1/2 percent is satisfactory. Suppose the dynamics lead us to 3 or 3-1/2 or even 4 percent. I think that would make me happy. I think it would move the economy in the right direction; it would help us get around some of these financial problems. So, if we erred in that direction, I think it would be a plus. On the other hand, suppose we erred in the other direction. Suppose we end up with 2 or 1-1/2 or 1 percent. I think that would bring forth a number of negatives in the economy. So, even though it is a good forecast, and I think that the risks are probably about even as to whether it will be up or down from that, I would much prefer if I could do it to be on the high side, at about 2-1/2 percent. And that has some implications for monetary policy, which I think are appropriately dealt with later.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. We had some events in our District recently that might have some implications for the investment outlook. We have had an unusual number of write-offs of properties in some of our industries. Olgivie Norton wrote off a major part of its iron ore assets. Sohio wrote off major amounts in both copper and Carborundum. There are some big write-offs from U.S. Steel as well. If one were to generalize from these few situations, I suppose one could say that in basic industries and in basic materials within those industries we have a situation that would not be consistent with investment strength next year. That also goes along with my view of the investment outlook for next year.

CHAIRMAN VOLCKER. Mr. Griffith.

MR. GRIFFITH. The Twelfth District staff forecasts a 3 percent GNP growth, but I would note that some of the assumptions used in that have been described this morning as fragile. In our forecast we give a lot more credit to the depreciation of the dollar as [a factor stimulating] the trade account next year--a $15 billion improvement versus, I think, the Board staff's $6 billion. We assume that there in fact will be a 50 to 70 basis point decline in the commercial paper rate. But most importantly, thinking back to some earlier comments, we assume that whatever reduction of interest rates occurs will be front-loaded--that it will have to occur in the first part of the year to achieve any of this growth. And, although less important, another assumption made in our staff forecast is that the price of oil will get to a low of $21.50 by year-end 1986.

As far as the Twelfth District is concerned, it is relatively unchanged from our report last time. Unemployment is staying around 7.6 percent and we are continuing to experience significant [weakness], as you are well aware, in the wood products sector as well as in electronics, semi-conductors, and agriculture.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. I think it's extraordinarily difficult to have a forecast of the economy at this time. I could see the economy being stronger or weaker than the staff projection. I really don't have any idea how it is going to turn out. In a situation like that, I think it's best to look at the forces--as Frank did and as Jerry talked about--without line-by-line projections, to see which way these various forces are moving. I am very impressed by two assumptions. One is that the decline in the dollar that we have had, which seems to be extremely satisfactory, has to be for the good as 1986 goes on. I don't want to put a number on it, as you just did, because I think it's awfully hard to say. We have so little experience to [help us] know what responses in buying patterns will occur with changes in the exchange rate. And I am impressed by Pres' comment that there is a more bellicose attitude in the foreign trade [arena] by us and others than there has been before, so that in fact we might not get the full effect [of the dollar decline]. But it is certainly to the good. Also, both the decline in long-term interest rates and the rise in stock prices, which I never really dreamed would occur in the last month, are desirable outcomes from the standpoint of increasing confidence and reducing to some degree the debt service burden that's involved in our very, very heavy debt load. So, those are both quite favorable developments; I agree with Frank on that.

I think there is a heaviness in the economy that is probably due to uncertainty and the fact that it's getting to be a pretty old expansion now and there is not much momentum that anybody can see in plant and equipment that would carry this expansion any appreciable degree upward in the period to come. And there is this housing situation, which I think is quite extraordinary. I really thought last month's housing start number was the right number and that the previous number had been too low. Now, with November, we are back where we were with the previous number. Something is apparently going on there that is making that sector less responsive to changes in interest rates than it historically has been. I also think that regardless of whether we get tax reform or not next year there is going to be a letdown in the economy, because I believe a lot of things have gone on--particularly in the second half of this year--in anticipation of some tax action next year, which won't be worth the candle once we get beyond 1985. So, whether or not there is tax reform, the incentive to spend or to speed up spending commitments in the hopes of getting out of the increased taxation has already occurred and there will be a letdown. I conclude, as I did last time, pretty much as Ed Boehne did: that it doesn't look like very much growth in the economy next year. I am not sure whether it's 1 or 2 or possibly 3 percent, but it doesn't look like very much. So, any erring should be on the side of ease, I think, in order to try to encourage a little more expansion in the economy if we can get it. I am particularly impressed that there hasn't been that much movement in short rates as the whole rest of the structure has adjusted downward. So I think it is probably time to [lend] a little helping hand and go on down a notch in short-term rates.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. First, on Jerry's comments about the responses to the lower dollar: I think I mentioned last time that I talked to a major national retailer based in our area about price responses, and I had an opportunity to ask that question again just a week or so ago. In terms of textiles and apparel, in particular, what they are being told in Japan is that unless they are prepared to pay price increases of 10 to 15 percent on those goods, delivery can't really be assured. Now, that's not at all the case in areas such as electronics where there is a lot more softness in the markets; but I think we could see some relatively rapid responses both in terms of shifting business activity and prices as a result of that. The second comment is that, particularly in view of the response in the long-term bond market to Gramm-Rudman, I was somewhat intrigued a couple of weeks ago with the idea of that somehow providing some room for more accommodation on the part of the Fed. But I guess I would have to say I am from Missouri on that: I would have to be shown. I think that the amount of actual reduction we could get in fiscal 1986, as reflected in Jim's forecast, is next to negligible. And who knows what conditions--in terms of new legislation or an outlook for a recession or whatever--might interfere with it down the road? So, I think it's very positive that it has had the effect of apparently reducing inflationary expectations amongst long-term bond holders. But I guess I would say that more accommodation on the part of the Fed could actually run counter to that trend, particularly against the background of what some might view as an already very accommodative policy. So I think it's important that we not interfere, in a sense, with the process of that reduction in long-term inflationary expectations.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. Well, I think the economy has grown too slowly in 1985. I went back and looked at the information we put out at the time of the February Humphrey-Hawkins meeting and the July Humphrey-Hawkins meeting. Looking at the central tendencies that we published [in February] for real GNP growth for 1985, we had 3-1/2 to 4 percent. So it looks as if there are some other people who must be disappointed also in the performance. By July we had cut it back to 2-3/4 to 3 percent, but again that's above what we actually seem to be achieving for this year. Then I look at 1986 and the staff forecast of a rousing 2.1 percent growth rate and again compare that to the central tendency for 1986 as published in the July Humphrey-Hawkins Report. That was 2-1/2 to 3-1/4 percent. So again, it seems to me that we are running short of a number of our expectations. I guess what concerns me is that even to get this 2.1 percent in 1986 we have to assume additional monetary ease, a significant decline in interest rates. And we also assume--I think I heard Jim say--that about half of the improvement in real GNP next year will come from net exports. That means to me, anyway, that we will need further declines in the dollar. We all have our pet samples of people we talk to, and the group that I check my ideas with suggests that they have noticed the decline that has taken place, but they are not going to be in pig heaven without still further declines. I am also concerned about the impact that the tax reform proposals are having on the economy. I think it has created a lot of uncertainties and I am afraid, as Chuck said, that at some point the activities that had been based on beating the tax reforms in certain areas are going to evaporate and that will yank the rug out from under certain sectors of the economy. So having said all this, what I would like to propose is that we get going with this additional monetary ease and that we try to get interest rates moving down, in line with what the staff forecast is assuming. I would like to suggest that one reason why short rates haven't come down is that the discount rate is preventing them from moving down. That's just like an anchor, and I would hint that a one half percentage point cut in the discount rate would do great things to move a number of short-term rates down, including the prime rate.

CHAIRMAN VOLCKER. Anybody else who wants to be heard from? Why don't we get Mr. Axilrod.

MR. AXILROD. [Statement--see Appendix.]

CHAIRMAN VOLCKER. [Unintelligible.]

MR. BOEHNE. May we ask some technical questions or are we going to break? Our borrowing assumptions are a little complicated by the air of uncertainty that hangs over the table concerning the discount rate. I am trying to get [it straight] in my own mind. Suppose we had a discount rate of 7 percent versus the current discount rate of 7-1/2 percent. What in your judgment are the equivalent borrowing and discount rate assumptions in terms of their money market effects? In other words, is a $200 million borrowing assumption with a 7-1/2 percent discount rate roughly the equivalent of a $400 million borrowing assumption and a 7 percent discount rate? Or how does one trade that off?

MR. AXILROD. With a $400 million borrowing assumption, under current discount rates--I would not put too fine a point on it--it would take a funds rate somewhere on the order of 7-7/8 percent or a tick higher, something like that. So that's just [over] the discount rate. And at least in my judgment, the funds rate has not reflected expectations of a discount rate cut to any significant degree yet in the sense that other market rates have. I'd expect that if the discount rate were 7 percent, the funds rate would be almost, but not quite, half a point lower than that 7-7/8 percent.

MR. BOEHNE. At what borrowing levels?

MR. AXILROD. Given the same borrowing. It's hard to say, but I would put it at 7-3/8 or 7-1/2 percent--in that range. I defer to Mr. Sternlight.

MR. STERNLIGHT. Well, I think you are right. I think that a half percentage point move on the discount rate would bring funds down about that same half percentage point. It could be a little less because maybe a move has been discounted to a tiny degree. But if it set expectations going of things being on the easy side, you could get that full half point on the funds rate.

MR. BOEHNE. And that's with borrowing at the current level?

MR. STERNLIGHT. I think $400 million is a little more assured of getting a rate under 8 percent now than $450 million.

MR. BOEHNE. And if we have alternative A as presented in the Bluebook, assuming a 7-1/2 percent discount rate, that would give a funds rate of what?

MR. AXILROD. I would think very close to 7 percent, if the market sensed there was an easing. No, I mean right around 7-1/2 percent--roughly equivalent [to the discount rate]. I don't think that you can ease bank reserve positions without setting up considerable expectations on the discount rate. I am not sure where but I think the interaction would drive rates down; it could drive the funds rate pretty sharply at first.

MR. GUFFEY. If I can just follow on that question a minute. If we were to take "A" without a discount rate decrease and we got a 7-1/2 percent funds rate with $200 to $250 million in borrowing as projected in the Bluebook and then we had a discount rate decrease, that would be a double whammy if you will, and the rate would get down to 7-1/4 to 7-3/8 percent, I assume. Is that--?

MR. AXILROD. Well, I would think it would get down. If the discount rate were reduced to 7 percent--depending on the timing and direction of these--you would get the fed funds rate pretty much down from the discount rate. You would get not the minimal but close to the minimal.

MR. STERNLIGHT. I think if you went for something like $200 million, the easier reserve conditions, there would be such a strong expectation of the discount rate following that you would get that very strong expectational effect. And you could tend to get funds even below 7-1/2 percent before the discount rate moved.

MR. GUFFEY. And then a full half point after that?

MR. STERNLIGHT. Well, close to the half point after that.

MR. AXILROD. In that context, President Guffey, it might be useful to add that a combination like that--again, depending on how it's done--would have, in my view anyhow, a rather powerful effect on exchange rates.

MR. GUFFEY. Well, the practical alternatives would be "A" with a discount rate change or "B" without a discount rate change, I guess. No, "A" without a discount rate--

MR. PARTEE. No, "A" without a discount rate change, or "B" with one.

MR. GUFFEY. If you have "A" without, you would set in motion expectations that [a discount rate move] would be forthcoming.

CHAIRMAN VOLCKER. We'll go eat a donut.

[Coffee break]

CHAIRMAN VOLCKER. Well, indeed, we have to arrive at a little decision here. I listened very carefully to what you all said this morning. I'm not sure it eliminated all the confusion that might exist or the differences in views around the table. I must say I think we're in a rather strange situation historically: Three years of expansion and nobody's very happy. The economy, from one point of view, seems to be stumbling a bit. There is not a very good growth trend in the gross national product, but I remind you that the unemployment rate has been trending down very slightly and not up. When we look at those gross national product figures it mesmerizes us. I put it in the perspective that unemployment has been edging down and not up. Our productivity has been rather dismal. When I look at what we're doing in terms of stimulus or spending it's pretty good. Gross domestic purchases for the last three quarters have risen 3.9, 3.2, and 5.3 percent. Domestic final purchases have risen 4.1, 6.4, and 4.1 percent--not exactly an economy that is starved on the spending side. We have a decline in the trade balance, which arithmetically accounts for the low gross national product. There is a lot of speculation about whether that's going to be changing or not or to what degree. I guess nobody knows. There seems to be a consensus that it is not going to continue to get worse. One question is how fast the economy should be growing. I don't think I know the answer to that, but I would express a little skepticism, given the productivity performance, that a 4 percent rate is sustainable for all that long without creating inflationary problems. Maybe the higher growth will help the productivity, but I don't know how much. It should help it in manufacturing [unintelligible] but manufacturing is far from the whole of the economy. [Unintelligible] expansion in the rest of the economy and no productivity growth; I guess it's practically zero outside the manufacturing area. Is that right, Mr. Kichline?

MR. KICHLINE. For the current quarter?

CHAIRMAN VOLCKER. No, for the past year or so.

MR. KICHLINE. Yes.

MR. PARTEE. Zero?

MR. KICHLINE. Well, it's 2/10ths or something.

VICE CHAIRMAN CORRIGAN. It may even be negative outside manufacturing.

CHAIRMAN VOLCKER. It isn't high, whatever it is.

MR. KICHLINE. It's 1/10th in our forecast.

CHAIRMAN VOLCKER. Is that for the whole economy or just--?

MR. KICHLINE. No, the nonfarm business sector.

CHAIRMAN VOLCKER. So even with the increase--. So it's minus outside of manufacturing.

MR. PRELL. You can't really couple the two series that directly, but it sort of looks that way.

CHAIRMAN VOLCKER. The total is zero and manufacturing is up; it must look that way.

MR. PRELL. But it's a different statistical basis.

CHAIRMAN VOLCKER. Well, maybe so.

MR. PARTEE. You don't measure output properly in trade and services.

CHAIRMAN VOLCKER. Well, that may be right too, but--

VICE CHAIRMAN CORRIGAN. Or input.

CHAIRMAN VOLCKER. --it isn't very good. And we sit here debating whether to ease some more. In a way, that's not an uncomfortable position to be in. Usually 3 years after an expansion we worry about how much to tighten because we don't see any capacity out there and unemployment is too low, or appears to be too low, or we get inflationary pressures. None of those things exists. It's not the worst situation in the world. On the external side, I feel a little better about Europe. I might foresee a little faster growth there, or at least it's tending toward the more optimistic side; but it's certainly the reverse in Japan, where things look kind of sour.

Everything that has happened recently makes the Japanese economy look less favorable. We have a lot of problems in particular sectors of the economy. You all know that. We have problems with the LDC debt. None of these problems is going to be cured by easy money, but all of them might be assisted at the margin by an easing in money.

The greatest dichotomy is [monetary growth]. I jumped when I saw this Bluebook and the list on monetary and credit growth. If you look at the November figures, we're talking about: M1, up 13 percent; M2 and M3 rather moderate; domestic debt, up 16 percent; bank credit, up 16 percent; total reserves, up 20 percent; the monetary base, up 10 percent. If you just looked at those figures and you came from Mars you'd say "Geez, it's mildly expansionary." If you look at the bond markets, we have had a rally of--I don't know whether it's of record proportions, but it couldn't be going more nicely in terms of lower interest rates in that market; [the lower rates] may not affect much except U.S. Treasury borrowing costs and the mortgage market. Just a sidelight on this housing start figure: I heard a hypothesis from some major homebuilders of small houses who were in town about a month or six weeks ago. They said sales went dead in October, and we may be seeing some reflections of that in this current housing start figure. Why did they go dead? Well, they didn't fully understand it, but part of their reasoning was that people bought so many cars in August and September that they couldn't afford the downpayment on a new house. That was one reason. Another reason was that mortgage rates at that time were going down and everybody was anticipating further declines, and nobody wanted to go house hunting until they saw how much further mortgage rates were going to go down. They said if that was the reason, it was a pretty good forecast on the part of those potential home buyers. I don't know whether--

MR. MARTIN. Maybe that's their only floating rate. That's not so difficult to counter.

CHAIRMAN VOLCKER. What?

MR. MARTIN. You sell and close at whatever rate is then the lower rate.

MS. SEGER. You put them in ARMs.

MR. MARTIN. [Unintelligible] in today's technical--

MR. PARTEE. It's typically done, isn't it, Pres?

MR. MARTIN. Three or four months from now [unintelligible]. I don't think they gave you a very good reason, Paul.

CHAIRMAN VOLCKER. Oh, I don't know. It's the difference between seeing the bird in the hand and saying how you feel. If my forecast is so correct I'm going to [unintelligible]. With respect to why sales should go dead in October followed by [unintelligible] the builders apparently concluded that.

In any event, we have this situation where interest rates are going down very rapidly in the long-term markets and the stock market is going up at the same time. It's a rather strange--well, maybe it's not a strange combination--but it's kind of strange when you put into it that gold prices and silver prices are going down at the same time. Leading indicators have been up for a while. It is a situation that does not give me a great sense of urgency about the necessity to make drastic moves in policy at this stage, unless this clarifies itself one way or the other. The only other point I would make is that in terms of overt moves, and given the risks on the dollar side, I think it would be important to try and get some coordination with our trading partners. I'm not sure how easy that is or how difficult. It may be easier with some than with others at this stage, but that would need a little exploration. I don't hear anybody talking about any tightening. I presume the center of gravity is toward some easing so we can get these money and credit figures really moving! [Laughter.]

MR. RICE. They're perverse; they might turn around the other way.

CHAIRMAN VOLCKER. Maybe so.

MR. RICE. We tighten, then they move up.

CHAIRMAN VOLCKER. So, who would like to say something? Mr. Morris.

MR. MORRIS. Well, Mr. Chairman, if ours were a closed economy, I would support some lowering of interest rates at the moment. The forecast may be reasonable, but I don't think it's acceptable as a good target. I would share your concern about a 4 percent pattern of real growth, but it seems to me that 2 percent is not acceptable as a target; 3 percent would be more in line with what I think we ought to shoot for. But we're not a closed economy. We have overhanging us a necessity to continue to finance a $140 billion current account deficit. So we have to keep in mind what the gnomes of Zurich are thinking about us. I hate to alarm, I hate to recognize--

CHAIRMAN VOLCKER. All of us have a little gnome in the back of our heads.

MR. MORRIS. I think the gnomes would look at our situation and would say: "Well, the dollar is going down; the economic news is mixed but certainly not weak; and the perception is that monetary policy is very accommodative." What we actually have in the monetary numbers is a split decision: M1 and debt suggest a very expansionary policy; M2, M3, and total liquid assets suggest a moderate policy. If we could arrange to publish an M3 figure weekly and only publish M1 once a month, I think that people looking at the M3 numbers weekly would get a perception that U.S. monetary policy is not terribly accommodative and that might be helpful to us. But it seems to me in this situation that we ought to stick to a status quo policy until we get a trigger that will permit us to lower interest rates. One trigger would be a sustained upward turn in the dollar in the exchange markets. The gnomes, I think, would find it acceptable if we were to check that with a decline in short-term money rates. The other trigger might be a serious weakening in the economic news, which I don't think is terribly likely; I think we'll float along in this continued mixed situation without any serious weakness. I'm not thinking of that as a very great trigger. And the third trigger would be if the monetary aggregates, and particularly M1 because of it's signal value, should start coming in on the weak side. So until then, it seems to me that it's a little hazardous for us [to ease]; I don't think we can really make a very strong case that a move at this time is compatible with continued emphasis on inflation control. So, I think we ought to go with alternative B. But there's a long time until the next meeting; and if the dollar should start strengthening in the exchange markets, I would lead off with a cut in the discount rate.

CHAIRMAN VOLCKER. You reminded me of a couple more comments I wanted to make. When I talk about 4 percent [GNP growth], obviously, I would not be concerned about a 4 percent growth in some quarters for a period of time. My skepticism is really that if growth were sustained there for very long whether it would be desirable. Maybe we can do it and maybe we can't. But I think it would depend upon a considerably better productivity performance than anything we've seen lately or anything the figures give us hope about at the moment. You say it is a long time until the next meeting. I think a lot could go on here, including the possibility of a discount rate change, which may require a consultation--even fairly promptly. We just have to assume that, in terms of that [intermeeting] action and how it could be integrated conceivably with some foreign moves. I don't think we can sit here and sort out every permutation and combination of possible developments over the next whatever [time period] it is.

MR. BERNARD. Eight weeks.

CHAIRMAN VOLCKER. Eight weeks. So, I would think that's quite likely: that at some point, with shorter or somewhat longer notice, [a consultation] would be necessary. Mr. Boehne.

MR. BOEHNE. Well, I think we do have a window of opportunity here for some amount of modest easing and I think we ought to take advantage of it. There is room on the up side: As far as economic growth, I don't sense any real risks that the economy is going through the roof and will jeopardize the progress that we have made on inflation. It's true that foreign concerns are a constraint, and more of a constraint than we would like, but it strikes me that the climate is improved to make an easing move compared to where the situation was just a few weeks ago when the dollar seemed poised to drop; in contrast to that situation of several weeks ago, it has stabilized. The drop in the value of the dollar has shifted more to Europe rather than concentrating on Japan. So, the tone strikes me as being better. I think it would improve the chances of [not getting] a negative reaction if there were some kind of international coordination [on rate reductions]. I think that would be very helpful. But it seems to me that the basic climate has improved; it seems to me that we have a window of opportunity in financial markets. Many of the good things--the long bond rally as well as the stock market--I think have built into them some anticipation of an easing of monetary policy. If we do not follow through with some easing of monetary policy, I think we're talking about a backup in interest rates, and I think we don't want a backup in interest rates. As far as Gramm-Rudman, there are an awful lot of negatives and criticisms one can say about it. I don't know whether it would do a lot of good or a little good. But it seems to me that it is a nod in the direction of a policy mix that most of us have advocated: that is, a somewhat tighter fiscal policy and some easing of monetary policy. And without in any way expecting a whole lot in that area, it does seem to me that the passage of the bill does give us a bit of an opportunity. So, I think we have that window and I would take advantage of it. My preference would be for a drop in the discount rate, with alternative B and around $400 million as a borrowing specification. If a discount rate were not forthcoming, it seems to me that we might want to move toward something like an "A" minus to "B" plus in terms of the open market specifications, which might be, say, $200 to $300 million for borrowing. But I think it would be preferable to coordinate a discount rate cut with open market operations.

CHAIRMAN VOLCKER. Let me just make a comment on something you expressed. I'm not sure about your interpretation of long-term rates in the bond market. Maybe I read into it what I hope. I think it certainly has been influenced by Gramm-Rudman and the prospect of the oil price moving lower. Everybody has been talking about that for a year and it hasn't happened. But I would like to think that reflects partly a feeling about inflation--that it is less of a threat now--rather than [expectations of] an imminent monetary policy easing. If I thought it was mostly the latter--if much of it was based upon monetary policy easing--I'd have to ask myself why short-term rates haven't moved lower. [Unintelligible] my interpretation would be that it's very constructive in terms of inflationary expectations. I would hate to upset that; it would be counterproductive. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Ed Boehne has already said what I wanted to say, I think. I believe also that we have a window of opportunity and we should take advantage of it. With respect to the international situation, it seems to me that the threat of a precipitous drop in the dollar has perhaps not disappeared, but it certainly is much less than it was at the time of the last meeting. And I would ask you, Mr. Chairman--perhaps you can or cannot comment--with respect to some lower interest rates here, what is your best guess as to what Germany and Japan, for example, might do in terms of following us down? If they're satisfied with the current [exchange rate] levels of 2.50 and 200, for example, it would seem to me that there would be some leeway for them to move their interest rates down and thus become a bit more expansive in their own monetary policy and thus have some impact that would flow back to the United States over time by permitting them to attract more of our export markets. But having said all of that, it just seems to me that [we have a window here] with inflation not being a high visibility concern, though not at an acceptable level to be sure, and the Gramm-Rudman bill. And with the passage of that bill we may even have a bit of an obligation to give a nod to that by easing interest rates, if you consider that fiscal policy will be somewhat more restrictive than it has been in the past. And Gramm-Rudman will really have some impact. If there is a window, in view of the financial strains not only in the Midwest but throughout the United States and internationally, I think we ought to take advantage of it. Like Ed Boehne, I would prefer to coordinate it with a discount rate decrease rather than some easing through the Desk's actions and then a discount rate decrease that might have to come thereafter. So, I would do the discount rate decrease, leave borrowing at the $400 million level, approximately, and move interest rates down in that fashion rather than the other way.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Mr. Chairman, given my view of the economy, I don't think we really need to do anything at the moment. I think the economy is going to be somewhat better in 1986 than it has been in 1985. Certainly, my forecast is that it's going to be better than the staff's projections. So given that, I'm not concerned about the economy at the moment. I am concerned, however, that if we were to ease we might begin to lose some of the gains we've made in terms of inflationary expectations. Now, if the economy in the shorter term were to begin to turn down, or if we lost some of the gains we've had with respect to the foreign exchange value of the dollar or long-term rates--that is, if either of those began to back up--then I would support some easing in policy. As has been pointed out, we have been accommodative with respect to the monetary aggregates. I don't think anyone can say we haven't been. Of course, the question is how effective that has been in terms of moving the economy. But all things considered, I would prefer that we take a wait-and-see attitude; and that means, I suppose, alternative B with a borrowing level of around $400 to $450 million.

CHAIRMAN VOLCKER. Mr. Martin.

MR. MARTIN. Mr. Chairman, I think you were quite right in directing our attention to the growth in bank credit and total reserves and other factors. They are labeled here the key monetary aggregates. I think, though, particularly in terms of M1, what has come out of our discussion yesterday, which spills over to some of these other aggregates, is that given deregulation--given the pricing and the consumer reaction to new instruments and new spreads and new opportunity cost relationships--we really don't know what those figures mean. At least we don't know as much as we used to know about them. Secondly, it seems to me that the staff's forecast has not been demolished in our discussions earlier today. Therefore, with the forecast, which would be extant if we kept conditions as they are today with the adjustment and seasonal borrowings running $633 million in September, $558 million in October, and $672 million in November, it seems to me that we run a risk of recession--to get that word out in the discussion--rather than a 2 percent growth.

It seems to me also that your comments with regard to coordination are certainly in order. I believe in the technical information we've had with regard to a discount rate cut that what has been assumed here is 50 basis points. I haven't heard anyone mention 25 points; 50 points seems to have been implicit or explicit in the discussion. Plus a move to a configuration such as alternative A might be: (a) risky as far as the dollar falling; and (b) over-stimulative relative to what little we do know about these monetary aggregates anymore. So, I would like to see the Chairman and the staff use the alternative A course in conjunction with a future discount rate cut. I think there is merit in removing what appears to be the floor under short-term rates vis-a-vis long-term rates. I would hope that we would have an alternative A which would merge in the direction of alternative B down the road. I would hope that this Committee would give the Chairman an unusually wide band for the borrowing. I don't know what the band should be--perhaps $300 to $500 million or something rather wide so that this operation could take place. By this operation I mean to start easing in the market, moving toward $300 to $350 million so that the fed funds rate begins to come down, and to adjust the discount rate by 50 basis points and continue to work the Desk operations so that the borrowings firm up a little within that range, depending on the Chairman's judgment at that time, back to $400 million, let's say. At any rate, [I favor] a start toward providing a 50 basis point change at the short end. I think the market expects that and that we run the risk of its backing up on us, including in the short-term rates. That, as the Chairman indicates, is certainly a desirable direction. But as we all know rates are still at a very high level in real terms. And the staff was indicating this morning that the high real level of long-term rates helps produce 2 percent growth for another four quarters which, as has been commented here, is insufficient. We should do what we can to bring growth up some. Therefore, I vote for alternative A with a wide band around the borrowings; and I'm looking forward to a discount rate cut and some adjustment of the borrowings accordingly.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I was very close to what I take to be your position and that expressed by Bob Forrestal. And I thought for awhile that I might make history by agreeing with Frank Morris, but he went a little too far for me! I was very much encouraged by the slowing we thought we saw in the aggregates at the time of the last meeting. But I'm equally discouraged by what has happened since then, and in particular by the rapid growth in currency and demand deposits as well as OCDs--the M1 target. And that really scares me, as far as the implications for down the road. So I think "B" is as easy as we really ought to think about being at this point. As the Bluebook points out and as we all know, of course, it's particularly difficult to judge what's going to happen to the aggregates with a given borrowing level. So I am more interested, I guess, in what our response would be to deviations in the any of the aggregates in the event that they don't come in on target. For example, if M1 should come in at 12 or 13 percent instead of the 7-1/2 percent projected under alternative B, then I would hope that we would move the borrowing target up. Similarly, if M1 came in weak, I'd be glad to lower that [target] somewhat. And I would prefer "would," obviously, in the directive wording rather than "might," although I know you don't see a lot of difference in those. As long as you would interpret "might" to mean that you <u>would</u> move the borrowing target up I could go along with "might," but perhaps it--

CHAIRMAN VOLCKER. Honesty compels me to say that we have not been terribly sensitive to small changes in M1, but higher concern--

MR. BLACK. I'm aware of that. But you did paint a picture of a lot of liquidity that we had pumped into the economy, or so I interpreted your remarks. So I would hope there would be a bit more sensitivity to additions in liquidity on top of that.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. It seems to me, as we discussed earlier, that there have been a lot of significant developments over the past 5 or 6 weeks, including the run-up in stock prices, the decline in long-term rates, developments with regard to OPEC, and Gramm-Rudman. With regard to OPEC and to Gramm-Rudman even with all its blemishes, the implication, at least to me, is that inflationary expectations have been reduced. And in the current setting, that's a significant development. It leads me to the view that the proper specifications for policy at this time now are somewhere between "A" and "B." I come to that conclusion largely on the consideration that lower nominal rates would be associated with essentially the same real rate in this environment, if inflationary expectations have diminished. So, that's where I would go. With someplace in between "A" and "B" I think we will get an acceptable economic performance in 1986, as best I can judge the situation. I kind of put aside the discount rate for the moment although, obviously, that's another way of going--depending, I suspect, on your comments about coordination.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Well, I tend to support the position laid out by Messrs. Boehne and Guffey. I do think there have been some important changes over the last few weeks and, as a consequence, that we have something of an opportunity here that we ought to take advantage of. The economic outlook, I think we agree, is positive. I don't think I heard anybody talk about a recession near term. But also I must say I don't have any sense that there's a significant risk of--

MR. PARTEE. I'd be prepared to talk about it, Si.

MR. MARTIN. I would too.

MR. KEEHN. Well, as I heard the comments, at least near term, I didn't hear that risk. But on the other side of that coin, I don't think I heard anybody suggest that we are significantly at risk of an overheated economy, at least near term. With regard to inflation, notwithstanding the Chairman's comments, people I talk to in terms of labor contracts, for example, are still negotiating very, very favorable contracts with good work rule changes. And in terms of pricing, the competition out there is just very, very rough. As a consequence, I have a positive outlook on the inflationary side. As for the exchange rates, it's always dangerous to talk about exchange rates because you have to be on the Desk to know what is really happening. But I have some fear, as I said yesterday, that while earlier we were concerned about a precipitous decline, maybe we are getting into an area of at least stability. The declines that we have had had such an important and positive effect here on those who were most affected, I'd like to try and provide an environment in which we could continue at least to stabilize and hopefully continue to get something of a decline. But it is the interest rate side where I think there is the biggest change. Yes, medium- and long-term rates have been going down for quite some while and short-term rates not so much. But, frankly, I think the discount rate at this point is something of a barrier to a further decline in short-term rates. As a consequence of all this, I think that the discount rate becomes terribly important in our considerations. If I had my druthers, I'd opt for alternative B with a reduction in the discount rate and the borrowing level maintained at, say, $400 to $450 million. But if timing were a complicated consideration and, therefore, if the discount rate were going to remain at its current level, I'd go for alternative A and reduce the borrowing level to the $200 to $250 million range.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. Well, as I indicated earlier, I am concerned about the slow growth in the economy that we've had this year and the staff forecast of a continuation of that next year. While I'm not one of the recession crowd at the moment, I think as we stagger along at a slow rate there is a vulnerability to a recession. I don't know what would push us in: a major financial institution failure or something. I don't know exactly what. Anyway, I think there is an underlying vulnerability there. Also, I agree that the short-term rate decline came to a halt some time ago and that it is not going to resume until the discount rate is cut. I would hope that we could take that step sometime soon. I think that this would help the dollar to drop somewhat further. I don't want it to drop 30 percent over a week's time, but I think it would help our basic industries tremendously to have some further decline in the dollar. Also, to the extent that we cut our interest rates, I think it would allow some of our trading partners to cut theirs. I don't know if it has to be absolutely coordinated, but I think it would at least give them the opportunity to do so, particularly the Japanese. So, my preference in terms of the alternatives would be something on the order of alternative A with a 1/2 point discount rate cut sometime soon, and the borrowings specifications in some fairly broad range because I'm not that impressed with my ability to identify specific narrow ranges with monetary growth outcomes.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I find the outlook for a 2 percent rate of [GNP] growth for 1986 unacceptable in the current circumstances. So I find myself in sympathy with the observations that have been made around the table by Messrs. Boehne and Guffey and also Mr. Stern. I would prefer an alternative somewhere between "A" and "B" for now. I tend to separate the reduction in pressures on reserves from the discount rate decision. I would prefer to ease pressure on bank reserves somewhat now and see what effect that has, and then make a discount rate decision in light of what happens when we ease somewhat. So for now I would come down somewhere between "A" and "B," holding in abeyance the discount rate reduction.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Mr. Chairman, as a number of people have pointed out, a lot of things have happened since the last meeting and maybe in one sense that does give us a bit of a window on monetary policy. Among the many things that have happened since the last meeting, one that I focus on particularly is the euphoria in financial markets combined with something that hasn't changed since the last meeting--the financial strains in the economy. Yesterday, there were a few brief comments exchanged about 1929 that I thought were quite interesting and it brings up the whole subject: If the Federal Reserve were in the business of trying to deal with the speculative mood in the economy, what would we do? I guess one could argue the financial strains issue either way on monetary policy: One could say that the strains are so great that we have to be careful and ease--we have to be careful always, of course--or that the way to take the speculation out would be to tighten. Altogether it comes down to the fact that monetary policy is a very big and heavy tool to use in this respect; I'd say our hands are kind of tied. I find myself, in addition to thinking a lot about discount rates at this meeting where they are not on the agenda, also thinking a lot about supervision and regulation, which is not on the agenda, because in order to deal with financial strains I suppose we're reduced to other tools besides monetary policy. In any case, with all of those considerations, on monetary policy I come down on the side of saying that I wouldn't change much from where we are today. I'd favor something like alternative B, and I think we do have room to go in the "B plus" direction.

MR. PARTEE. Is "B plus" toward "A"?

MS. HORN. Yes.

MR. PARTEE. Toward "A."

MS. HORN. I guess after all of these two hands--[on the one hand and on the other hand]--it's hard to know. Toward "A."

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. Well, I have a rather strong preference to work within the framework of alternative B. I certainly am not as sanguine as some are on this foreign exchange rate situation. I think we've done very, very well to date. I'm not uncomfortable with where we are, but I must say that as I read the situation I think the downside risks are still very much there. One could quibble about whether they're a shade less or more than they were a month or six weeks ago, but I certainly feel that they are there. Also, as I said yesterday, when I look at these financial aggregates and make some rough adjustments for what I think is really happening with M2 and M3, I come to the conclusion that in an underlying sense they all are growing very, very rapidly. And if I can take a little poetic license, when we talk about easing policy what in some sense we are saying is that we want people to go out and borrow some more. And when I look at what's already there, I'm just not quite sure that that's the right response. I think Karen has a point. You can almost, at least somewhat more abstractly, raise the question of whether given what is already there we should in some sense be looking at policy from a different vantage point altogether. But I don't think that's in the cards. In sum, I would want to work in the framework of alternative B. I think the nicest outcome that I could imagine would be one in which we could lower the discount rate in concert with other countries doing the same thing and end up with the borrowing sticking around the $400 million level. Now, I don't have the authority on either side of the coin to say whether that reduction in the discount rate should be 25 basis points or 50 basis points, but I think the question of 25 basis points is one that is at least worth serious consideration. On the question of what I would do if there were no prospect for some kind of a parallel movement in policy elsewhere--and, of course, that we won't know today--I think my druthers would be to stick more or less with the framework of "B" as is. But, again, if there were some opportunity for movement elsewhere in tandem with something by us, I think that would be fine. That would be the best of all possible outcomes, from my perspective.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, just briefly going back to the recitation you made in your opening comments, they indicated to me at least that we certainly have been accommodative any way you want to look at it. In terms of what is going on now--speculation, if you will--in the stock market and possibly some other areas, I would be very concerned to further fuel what [seem] to be the excesses. Certainly the debt side of it is excessive, from my view point at least. Every meeting is a critical meeting, but it seems to me this is probably one of the more critical meetings because the wrong turn right now could have very far reaching consequences. My view, as I expressed earlier, in terms of what I see for the economy for 1986 is slightly more optimistic than the Board staff's forecast. Having said all that, I would much prefer to stay right where we are which, if I read it right, would be alternative B. The ability to bring the discount rate down, if that should work out, I would find acceptable provided that that type of action wouldn't lead to too much euphoria otherwise. But I think that's manageable from the Desk side. So I would stay right where we are; I would stay with "B."

CHAIRMAN VOLCKER. There have been a lot of comments made about a speculative feeling in the financial markets. I guess I would look at it slightly differently now. I think there's excessive debt creation there; whether it's speculation or other motives, I don't know. It's certainly excessive in some very long-range perspective. So far as the bond and stock markets are concerned, I would like to interpret that constructively. I would hope that a 9-1/2 percent long-term Treasury bond rate is sustainable or normally reflects a reasonable appraisal of the outlook; it may still be high indeed. A 1,500 level on the stock market ought to be sustainable with a reasonable outlook. I think that's partly because people have changed their views on inflation, which is constructive. And I wouldn't want to undermine that by undermining what underlies it. That's my perception of it, myself. Mr. Melzer will tell us what the real attitudes are in the financial markets.

MR. MELZER. Well, I think the long-term bond market was discounting essentially nothing in terms of hope or progress on the fiscal side for quite a long period of time. We had a little flurry last May and then some of that was washed out. So I would be inclined to agree with what you said before: that even if the expectations of a discount rate cut that are in the market now were washed out, I don't think we'd give up the gains in the long end of the market. They may back up a little but they would not give up nearly as much as, say, the front end of the market might give up. I guess I'm a little reluctant to get caught up in that euphoria. As I said before, I think it could conceivably be a mistake to have a discount rate cut and easing of policy--or however an easing might take place--somehow tied to Gramm-Rudman. And I think people would try to do that based on what is on the table right now on that score. I also have a feeling that I'd like to see a little more evidence on what is happening in the economy right now because of these forces we've discussed and what I sense is going to be a pretty good Christmas season for retailers and so forth. I have a general reluctance to get caught up in a [view] that this just has to happen--that it's a one way bet and that's all there is to it. I would certainly be responsive down the road if foreign exchange market conditions or current evidence on the economy and other considerations indicated that there was room. But I'm not sure that this is the time. I have an aversion to, in effect, jumping on this bandwagon. So in terms of policy, I'd favor alternative B and might be sensitive to leaning toward alternative A under the right circumstances down the road.

CHAIRMAN VOLCKER. Mr. Griffith.

MR. GRIFFITH. I am personally totally uncertain as to what should happen. But having discussed this with John Balles and no one else, and having listened to this conversation, I think we want to be on record as just a little concerned that the forecast that our staff is making for 1986 on growth, as I indicated earlier, depends upon lowering the short rates very rapidly--front-loading early in the year to offset what may be sluggish spending in the last half of the year. So for that reason and other discussions that have gone on here about concerns that 2 percent growth may not be what we want to happen--or at least not sufficient or desirable--we find ourselves in the Guffey-Boehne camp at somewhere between alternatives A and B, with some ease. I think we would feel a little more strongly that there ought to be a discount rate cut to get the short rates moving downward.

CHAIRMAN VOLCKER. You're missing, Governor Partee.

MR. PARTEE. Well, I hadn't wanted to take any lead in this because it's you people who will suffer the consequences.

CHAIRMAN VOLCKER. We'll just blame whatever goes wrong on Mr. Partee!

MR. BLACK. Remember, you're going to be on a fixed income!

MR. PARTEE. I indicated before that my preference would be to ease up a little in terms of a somewhat lower level of short rates. I think we do have a window of opportunity. There is a good deal of expectation that this will happen in the market. I think the budget balancing bill--I doubt too that it's going to materialize as a serious move--but it gives a basis or reasoning that I think even foreigners could understand. And so--

CHAIRMAN VOLCKER. [Unintelligible.]

MR. PARTEE. Well, it might happen. After all, this is the most serious effort that has been made in a great many years to move consistently toward a balanced budget. And I think it will have a psychological effect so far as new programs are concerned.

CHAIRMAN VOLCKER. You said [unintelligible] that it wasn't serious.

MR. PARTEE. I suspect that there will be great difficulties with it. It is something that has occurred; it has been very much in the press and I think it gives us an opportunity. I also agree that it has been helpful to have a decline in long rates and that we probably will not hold the decline in long rates unless there is some move in short rates to help bolster what has occurred. So my preference would be for some easing. I think it's proper, as a number of you have done, to talk about this in the absence of a discount rate change because this is not a meeting in which the discount rate is considered. I can appreciate that there would have to be some negotiations and consultations and so forth with other parties abroad to see how everything would coordinate if that were to occur. So I would think that the best way to go, if the Committee wishes to move somewhat toward ease, would be--as Emmett and Gary suggested--between alternative A and alternative B with maybe $300 to $400 million in borrowing, which would be enough to begin to move the federal funds rate down. Now, I had expected that the federal funds rate was going to move down this last time between meetings. I thought that, other things equal, that is what we had rather agreed to do. It didn't move, at least enough so anybody could notice it in the market. But now I think it could move down 20 to 25 basis points without much trouble; and that could be consistent with either a 1/4 point cut or 1/2 point cut in the discount rate when the time comes to consider that. It would sort of set the stage for where I would have liked to have seen the meeting come out today.

CHAIRMAN VOLCKER. The discount rate is not a matter for this Committee, as you technically point out, but I would [be interested] nonetheless if anybody wanted to express any great feeling about a 1/4 or 1/2 point cut. We haven't done a 1/4 point for a long time--since '79 or '78. It's certainly getting down in a range where it has been done before. I don't know if anybody wants to comment on that.

MR. BLACK. If those are the only two alternatives, I'll take the 1/4 point. If there's a third, I have another thought.

CHAIRMAN VOLCKER. I'm not quite thinking of it in that perspective--that those are the only two alternatives. But I just [wondered] in general if there is anything to be said strongly one way or the other.

MR. GUFFEY. Well, I would prefer 1/2 percentage point. I can't remember how long it has been since we used the 1/4 point but that implies some precision that I believe we shouldn't try to demonstrate in the market. As a result I would object to a 1/4 point. If we're going to make a move, we ought to do 1/2 point.

MR. MARTIN. They have moved more in a week than they used to move in a presidential term! I think 25 basis points is almost--what is it that the advocates call it?--"de minimus" or some phrase.

VICE CHAIRMAN CORRIGAN. Small--

MR. GUFFEY. [Unintelligible] use that term to be--

MR. AXILROD. The last 1/4 point [discount rate change] I see was September 22, 1978 when we increased it from 7-3/4 to 8 percent.

VICE CHAIRMAN CORRIGAN. Well, the base is lower now than it was then.

MR. PARTEE. Yes, we're talking about a level of long rates that goes back to 1979.

VICE CHAIRMAN CORRIGAN. A 1/4 point move might also be perceived as saying that we want to keep some order in the bar.

MS. SEGER. You mean that we don't have any courage.

MR. BOEHNE. Keep--what did you say, Jerry?

VICE CHAIRMAN CORRIGAN. [Unintelligible.] Order in the bar.

MR. RICE. I think when it's not clear what we expect to happen we should do a 1/4 point; but when things are pretty clear we may as well move in 1/2 points.

CHAIRMAN VOLCKER. It depends on whether things are clear to you or not.

MR. RICE. Right.

MR. PARTEE. Emmett thinks they're clear. Well, I don't want to--

CHAIRMAN VOLCKER. I suppose it's anybody's bet. But I do not believe the long-term rate structure is dependent upon whether we change the discount rate or not. I think it is readily arguable that it would be perverse. I think the short-term rate structure is.

MR. PARTEE. Yes, I think it could use a little help.

CHAIRMAN VOLCKER. It goes up a point a day, including today, I take it. Well, nobody else wants to comment about the appropriate size of a discount rate cut I take it? So far as the international implication is concerned, there are two [countries] involved. One I think would be extremely reluctant to do anything. The other may be less reluctant.

MR. PARTEE. Hopefully, the second one is Japan. They certainly ought to move their rates down.

CHAIRMAN VOLCKER. Well, that's what I had in mind. From our standpoint that obviously would be very helpful. The economics seem to dictate it, but in a way I think we're psychologically more vulnerable on the other side. But the Germans are feeling quite content with themselves.

MR. GUFFEY. Well, if we took the lead that would suggest then that they might follow U.S. rates down. Is that--

CHAIRMAN VOLCKER. I think across the Pacific they're much more likely than across the Atlantic.

MR. RICE. So you're pessimistic about coordination in Europe?

CHAIRMAN VOLCKER. I'm 50 percent optimistic.

MR. PARTEE. The Pacific.

CHAIRMAN VOLCKER. I think you can get one side; I'm not sure about the other side. I'd be very skeptical on the other side. You may get an exchange rate realignment in Europe; I don't know whether that's good or bad. There's considerable pressure over there now.

Well, it's hard to read this as a great consensus. And since there are too many variables in the equation, it is neither a consensus nor by and large an enormous difference. The tactics make it very difficult. This is a little messier than I would like to make it, but let me try to suggest something. For the moment we have a somewhat lower level of borrowing, but not so far that we couldn't reverse it without being too obvious about it, if the discount rate went down. If the discount rate doesn't go down, we might want to press that further. If it does go down, we might adopt this strategy that a number of people have suggested of reducing the discount rate but not the borrowing, which means something like--particularly taking into account a minor point, but nonetheless one that is there, that seasonal borrowings are running very low--$350 to $400 million or $300 to $400 million at the moment, and going to the upper side of that or maybe above it if the discount rate went down by a half. If it doesn't go down, depending upon the aggregates and other things, we would push toward or beyond the low side. If the discount rate goes down, or if it doesn't go down, we could reconsider or fine tune that after New Year's Day. I will be more specific: Assuming the discount rate doesn't go down, I think a borrowing number of $300-$400 million or something like $350 million would be the mechanical number the staff puts down [in the path] for the next week or so.

MR. PARTEE. Do you expect that to bring the funds rate--of course this is a very difficult period with the funds rate--

CHAIRMAN VOLCKER. Well, the funds rate is coming down, I think. It has a lot of psychology in it; it surprised me a little. If the discount rate expectations are all that strong, why has the funds rate stayed so high? I'm not sure that they have been all that strong. But it seems to be coming down a little now. I don't know whether that's lasting or not, but I would guess that we are talking about no more than 7-3/4 percent and maybe a lower discount rate, depending upon the anticipation. You fellows down the end of the table can refute that if you want.

MR. AXILROD. That seems reasonable.

CHAIRMAN VOLCKER. You made a comment earlier that if expectations of a discount rate cut really became strong, then short-term rates will go down before the discount rate cut.

MR. PARTEE. Do you agree that $350 million sounds like 7-3/4 percent?

MR. AXILROD. Yes, but that to me would mean as a practical matter that it would be under $350 million most of the days of the 14-day period. It's a funny business. You can't quite tell where--so I think you just have to be guided by the interaction of the funds rate and the movement of the borrowing.

MR. KEEHN. I agree with the approach. I just wonder operationally if that's a wide enough band for you to operate with or whether you ought not to have a little more--

CHAIRMAN VOLCKER. Well, I figure it's wide enough for the moment. But, as I said, I might consider a wider band in opposite directions [depending on] whether or not the discount rate changes: wider on the up side if it did change, particularly by a half; and wider on the down side if it didn't change.

MR. KEEHN. That was my point. If, say, you pick a range of $250 to $450 million, you might accomplish that.

CHAIRMAN VOLCKER. Well, that's consistent with what I said, if you conceive of the upper side as an after the discount rate cut [level] and the lower side as a no discount rate cut [level] over the space of the next two or three weeks.

MR. GUFFEY. But starting out at the $300 million level until this all unfolds?

CHAIRMAN VOLCKER. $350 million, I think I said.

MR. GUFFEY. I meant $350 million.

CHAIRMAN VOLCKER. Assuming no discount rate cut, $350 million and possibly moving lower, depending upon developments. It's $350 million, possibly moving higher, if the discount rate is cut--again depending on developments. And we will explore the discount rate possibilities abroad.

MR. GUFFEY(?). Are we at $450 or $400 million now?

MR. STERNLIGHT. We've been using $450 million in the path. Actually, so far in this period, which ends tomorrow, borrowing has averaged just $200 million because, as Steve said, we tend to get low levels until the very end of the period.

CHAIRMAN VOLCKER. The federal funds rate is close to 7-3/4 percent today?

MR. STERNLIGHT. It was 7-13/16 percent the last I heard.

CHAIRMAN VOLCKER. It's pretty close. I don't know whether these numbers on the aggregates mean anything in any of these.

MR. MARTIN. M1 doesn't.

MR. PARTEE. Do we give December-to-March or November-to-March [figures]?

VICE CHAIRMAN CORRIGAN. Use November to March.

CHAIRMAN VOLCKER. Is that what we have usually done at this time?

MR. AXILROD. Yes, the Committee has mostly used the November-to-March rates; it did last time. One thought that the staff had was that if the November-to-March period wasn't used, in some sense the aggregates look ignored in the last part of December. But the Committee may wish to do that.

CHAIRMAN VOLCKER. Do you feel strongly that M3 is going to be a little lower than M2? Given the uncertainties surrounding all of these figures, it's nicer to use one figure.

MR. AXILROD. I don't feel strongly at all about that, Mr. Chairman. The special circumstances are that we think there might not be many municipal issues suddenly after the beginning of the year and banks may not participate, therefore, as actively. But for all we know they could start buying governments instead.

CHAIRMAN VOLCKER. Just given the vast amounts of uncertainty in these numbers--. We had the same number [for both] last time, didn't we? For several times? Wasn't it the equivalent of 6 percent?

MR. AXILROD. To me, Mr. Chairman, it would be sensible to give a small range for both.

CHAIRMAN VOLCKER. The same small range?

MR. AXILROD. I think that that would be reasonable.

CHAIRMAN VOLCKER. I wonder if we have to say something indirectly or directly about the discount rate in the directive. It's a little misleading, whatever we say, to leave it out.

MR. MARTIN. They certainly expect it. The media discussion has been revolving around the area of the discount rate and policy.

MR. RICE. But they won't see it for a while; we would have done something or not.

MR. MARTIN. It's a little artificial to look as though we ignored the discount rate.

MR. BLACK. It will be February before anybody knows what we said anyway, so I think we ought to go ahead and mention it.

CHAIRMAN VOLCKER. Well, if we mention it, it's a question of where to mention it, I guess. Consistent with what we said, we presumably say we decreased "somewhat" or "slightly" the existing degree of pressure on reserve positions. I'm just thinking. "Somewhat greater reserve restraint--"

MR. BLACK. Since we don't mention the borrowing target, it's kind of hard to mention the discount rate, since the two are linked, and I think--

CHAIRMAN VOLCKER. Well, "degree of pressure on reserve positions" is our euphemism for the borrowing target.

MR. BOEHNE. What if in lines 79-81 [of the draft directive], where we have "taking account of appraisals" etc., we just have a comma and a fifth item "taking into account possible actions on the discount rate" or something like that. Just say "conditions in domestic and international credit markets, including a possible change in the discount rate."

CHAIRMAN VOLCKER. How would that be read if we did it that way? It might be read that if the discount rate were decreased, we would decrease reserve pressures further, and we are saying the opposite.

MR. PARTEE. That's not as clear.

MR. AXILROD. You could put it on the line after the first sentence, Mr. Chairman, saying "taking account of the impact of the a discount rate action should one be taken," or something like that.

MR. MARTIN. Yes, it goes there better.

MR. AXILROD. "The existing degree of reserve pressures, taking account of--"

MR. BOEHNE. I think that is better.

CHAIRMAN VOLCKER. It doesn't exactly clear up that ambiguity.

MR. AXILROD. It indicates the area.

CHAIRMAN VOLCKER. I don't reject that suggestion, but I suppose if we said "In the implementation of policy the Committee seeks to decrease somewhat the existing degree of pressure on reserve positions, particularly should the discount rate be maintained at current levels"--

MR. PARTEE. "Particularly in the absence of any change in the discount rate"? It seems a little odd.

MR. BOEHNE. It's a little strained. I think we have to have a more general statement than that. We comment on something that might not happen, and we have control over it.

MR. PARTEE. Why didn't you do it?

CHAIRMAN VOLCKER. We are talking here about "may"--

MR. RICE. It's prospective.

CHAIRMAN VOLCKER. We just put in there "taking account"--

MR. PARTEE. I really think, Mr. Chairman, the better way to do it would be to go without it, and then adjust this if there is a discount rate, which we have done before.

MR. GUFFEY. We could adjourn this meeting and the Board could adjust the discount rate and clear the whole thing up.

MR. PARTEE. Actually, Roger, I don't think we're talking about anything quite that immediate. Well, I think--

CHAIRMAN VOLCKER. Well, I think if we don't mention it here [in the directive] we should say something about it in the policy record discussion. If the discount rate is changed, we could have a consultation and follow that by a paragraph--

MR. PARTEE. And it even becomes a part of the same minutes.

MR. MELZER. That would be cleaner, I think.

CHAIRMAN VOLCKER. All right, we will put something in the record--as it should appear anyway, because it has been in the discussion--that would make this point clear as to what direction we are talking about. So then we just say "decrease somewhat."

MR. PARTEE. And we are going to say "this action is expected to be consistent with" targets--

CHAIRMAN VOLCKER. It's hard to call what we have "pressure," but--

MR. PARTEE. If we just say growth, it doesn't have to specify the amount for M2 and M3. "This action is expected to be consistent with growth in M1, M2 and M3." Forget any number.

CHAIRMAN VOLCKER. The trouble with these very low levels of borrowing is that we get that level of borrowing from computer breakdowns sometime.

MR. AXILROD. I think that the Committee ought to recognize, Mr. Chairman, that a lot of those high numbers of $600 and $700 million do come from that sort of thing. Even a $2 billion breakdown can--

CHAIRMAN VOLCKER. "Seeks generally to decrease somewhat the existing degree of computer-adjusted pressures on--"

VICE CHAIRMAN CORRIGAN. Really "seeks to increase somewhat the reliability of the computers!"

CHAIRMAN VOLCKER. Well, we keep this ritual of saying "is expected to be consistent with"--. Shall we demote M1 a bit by taking it out again?

MR. MARTIN. Let's demote it as much as we can.

CHAIRMAN VOLCKER. "This action is expected to be consistent with growth in M2 and M3 over the period from November to March at annual rates of about--". If you really wanted a wide range, I guess you would say--

MS. SEGER. 5 to 10 percent?

MR. BOEHNE. 6 to 9 percent.

CHAIRMAN VOLCKER. 6 to 8 percent.

MS. SEGER. That's true?

CHAIRMAN VOLCKER. 6 to 7 percent?

MR. PARTEE. 6 to 7 percent is a little thin, isn't it, considering the differences in these projections?

CHAIRMAN VOLCKER. 6 to 8 percent takes in the full range, then.

VICE CHAIRMAN CORRIGAN. How does the sentence read as you have it?

CHAIRMAN VOLCKER. "This action is expected to be consistent with growth in M2 and M3 over the period from November to March at annual rates of about 6 to 8 percent."

MR. PARTEE. I don't see any great harm in that. It's an acceptable range. M1, I guess, [may be] about 9 percent.

CHAIRMAN VOLCKER. Well, on M1 we don't know.

MR. MARTIN. 9 percent plus or minus 6 percent.

VICE CHAIRMAN CORRIGAN. How about a sentence that said that the Committee expects the action to be consistent with growth of all of the monetary aggregates at rates of 6 to 8 percent and then a phrase something like "recognizing that there continues to be especially large uncertainty about M1."

MR. PARTEE. It's hard to get [M1] down to 6 to 8 percent. I feel that anything could happen. Right now, the staff is expecting a large December.

CHAIRMAN VOLCKER. The latest estimate for December, for what it is worth, isn't all that much. It's what: around 10 percent?

MR. AXILROD. Yes. It gives a little more credibility to our 8 percent under "B."

MR. MARTIN. It's more like 7 to 10 percent, isn't it? Seriously.

MR. AXILROD. We have a little more confidence that M1 might make the top of the 6 to 8 percent range over the four months.

VICE CHAIRMAN CORRIGAN. It already has. December was--

MR. MARTIN. [Unintelligible] it and missing it all the time.

VICE CHAIRMAN CORRIGAN. But December was at 15 percent for purposes of the Bluebook, wasn't it?

MR. AXILROD. 14-1/2 percent--something like that.

CHAIRMAN VOLCKER. But that shows [the uncertainty]. We are dealing with an aggregate that three days ago the staff estimated at 15 percent and now they are estimating it at 10 percent for a month that's half over. I don't know exactly what we should write down. We can take something like 7 to 10 percent. Anybody have an inspiration?

MR. BLACK. I like what Jerry said, Mr. Chairman.

VICE CHAIRMAN CORRIGAN. What's wrong with that? "The action is expected to be consistent with growth in the three aggregates in the range of 6 to 8 (or 6 to 8-1/2) percent keeping in mind that M1 in particular still is subject to great uncertainties." Have a single range for all 3 aggregates rather than having a specific number for any one of the three.

CHAIRMAN VOLCKER. We could start off the sentence by saying "While recognizing that particular uncertainties surround the behavior of M1--." Well, that's all right with me if people are willing to live with 6 to 8 percent. I guess we take the curse off the 6 to 8 percent for M1 by the initial clause.

VICE CHAIRMAN CORRIGAN. Again, it's in a framework where I am assuming that the borrowing arrangements are as you described before.

CHAIRMAN VOLCKER. Well, I'm just referring to the fact that the range for M1 for what it is worth--and I don't think it's worth much--is running below any of the numbers for M1 except for those in alternative C.

VICE CHAIRMAN CORRIGAN. I don't care if it's 8 or 8-1/2 percent [as the top].

MR. PARTEE. I really think that phrase ought to be at the end of the sentence, Paul.

MR. MARTIN. But Jerry, I thought the staff number for borrowing was $200 to $250 and they had 9-1/2 percent on M1. No?

MR. AXILROD. That's right.

MR. MARTIN. Okay--then we start off missing it.

MR. AXILROD. Well, we wouldn't have changed--or I wouldn't have, in any event--our December-to-March estimate given the more recent December figures. I would view that not entirely but slightly independently. It would be lower under alternative [C]; our December-to-March estimate was around 8 percent, with December 14-1/2 percent. I wouldn't be tempted to change that because of this number.

MR. PARTEE. "The Committee expects...although it recognizes that there has been unusual volatility and uncertainty in the behavior of M1." Just because the first one says "consistent with that action" in the second one, where it started out with a parenthetical phrase, I think we say what we would expect.

CHAIRMAN VOLCKER. Well, I think the basic trouble is whether it is really worth trying to get M1 in that same range. I think it's a little tough.

MR. MARTIN. I would rather take it out.

MR. MELZER. You could use the prior structure.

MR. AXILROD. You could use 7 to 9 percent for M1, Mr. Chairman, which would not be too inconsistent with all of this--indicating it's slightly higher.

MR. MARTIN. I would rather take it out. Treat it separately; it's a separate behavior. This is the one that hasn't been near the middle or top of the range; it has been off the charts. People know it has been off the charts.

CHAIRMAN VOLCKER. I think that's probably better too [unintelligible]. Go back to the second [sentence] and say "expected to be consistent with growth in M2 and M3 of 6 to 8 percent." Semicolon. Do we need this phrase "assuming little net impact on the aggregates"? It implies a degree of knowledge we don't have anyway.

MR. AXILROD. Well, you don't absolutely need it. We could put it in the policy record, perhaps. It's just a little safeguard, since we don't quite know what's going to happen.

CHAIRMAN VOLCKER. Just put a semicolon and then "while M1 is expected to grow between 7 to 9 percent, the Committee recognizes the exceptional range of uncertainty surrounding that aggregate."

MR. MARTIN. 7 to 10 percent?

VICE CHAIRMAN CORRIGAN. 10 percent isn't even on the charts.

MR. MARTIN. Neither is M1 on the charts.

MR. RICE. 7 to 9-1/2 percent?

MR. PARTEE. "M1 behavior continues to be subject to unusual uncertainty but may grow in a range of 7 to 9 percent--." The half is--well, 7 to 10 percent is a lot better than 7 to 9-1/2 percent, but 10 percent is a high number and if it says <u>may</u> grow in a range of 7 to 9 percent we get--

MR. MARTIN. May or may not grow?

MR. PARTEE. You would say "may not"?

MS. SEGER. How about "will likely grow at some unknown speed"!

MR. PARTEE. It's important to say M1 behavior is subject to unusual uncertainty.

CHAIRMAN VOLCKER. Put a semicolon and "while the behavior of M1 has been subject to unusual uncertainty, growth of 7 to 9 percent over the period is anticipated." Is that all right?

MR. BOEHNE. Would you care to review it the way you have it now?

CHAIRMAN VOLCKER. It says "decrease somewhat" in the first sentence. "This action is expected to be consistent with growth in M2 and M3 over the period from November to March at annual rates of 6 to 8 percent; while the behavior of M1 has been subject to unusual uncertainty, growth of 7 to 9 percent over the period is anticipated."

MR. STERN. Better stick an "annual rate" in there, I guess.

VICE CHAIRMAN CORRIGAN. Things aren't that bad.

MR. PARTEE. Instead of "has been subject to" why don't we make it "continues to be subject to"? [Unintelligible.]

CHAIRMAN VOLCKER. Let's look at this next sentence. Do we want after the "be acceptable" to take out the "taking account of"?

MR. MARTIN. The foreign exchange markets part--

MR. PARTEE. We must still be affected by the domestic business situation.

CHAIRMAN VOLCKER. But in reality I'd be putting foreign exchange markets [first] if I were doing it. Not that I'd argue this, but from an operational standpoint that's much more likely to have an important change in a matter of weeks than the business situation. There is some merit in that.

MR. PARTEE. Conditions in domestic and international credit markets also may have more operational significance.

CHAIRMAN VOLCKER. I would agree with that too.

MR. PARTEE. If there's a collapse someplace that would probably affect us.

CHAIRMAN VOLCKER. Well, I wouldn't be allergic to putting business expansion and progress against inflation last. In an operational sense, probably, that's the order in which they come. We probably won't get a sharp change in the inflationary situation in the next few weeks either. In the first place, do we take out "taking account of"? It's probably a little more accurate, but I wouldn't bleed or die [over it].

MR. MARTIN. We'd be criticized if we didn't have it in there.

MR. RICE. No, I don't think so.

MR. PARTEE. We would still have them in there; we just take out the phrase "taking account of."

MR. RICE. That's really elevating those things.

CHAIRMAN VOLCKER. It elevates them slightly.

MR. PARTEE. Yes, I think it does. It puts them on an equal plane.

VICE CHAIRMAN CORRIGAN. Now what do you have?

CHAIRMAN VOLCKER. "...be acceptable depending on behavior of the aggregates, appraisal of the strength of business expansion, developments in foreign exchange markets," etc.

MR. GUFFEY. You do not have a reference to the discount rate in the directive, then?

CHAIRMAN VOLCKER. We agreed not to. "Taking account of" is out.

MR. MARTIN. Do you want to take "appraisals" out?

CHAIRMAN VOLCKER. I don't think it makes any difference.

MR. PARTEE. The difference is the perception.

CHAIRMAN VOLCKER. Oh! But you are probably right; the "appraisals" now refers to all of them. It might be better to take out "appraisals of" to avoid distinctions between appraisals of the strength of the business expansion and developments in foreign exchange markets. Does anybody else have any suggestions? Does everybody know how it reads? "In the implementation of policy for the near term the Committee seeks to decrease somewhat..." Is "somewhat" the right word?

MR. RICE. Yes, that's right.

CHAIRMAN VOLCKER. "...the existing degree of pressure on reserve positions. This action is expected to be consistent with growth in M2 and M3 over the period from November to March at an annual rate of 6 to 8 percent; while the behavior of M1 continues to be subject to unusual uncertainty, growth at an annual rate of 7 to 9 percent is anticipated. Somewhat greater reserve restraint..." What do you want to do with these "woulds" and "mights"?

MR. MARTIN. Rephrase it "might" and "would."

CHAIRMAN VOLCKER. Leave it "might" and "would"?

SEVERAL. Yes.

CHAIRMAN VOLCKER. "...be acceptable depending on behavior of the aggregates, the strength of the business expansion, developments in foreign exchange markets, progress against inflation, and conditions in domestic and international credit markets." When I look at this I really wouldn't mind changing the order of those last things.

VICE CHAIRMAN CORRIGAN. I wouldn't change it from that structure.

CHAIRMAN VOLCKER. Operationally, I think it's more accurate that way. Do you want to change it?

MR. PARTEE. I would rather not.

MR. MARTIN. Don't change it.

CHAIRMAN VOLCKER. It isn't a big point. Do you have any overwhelming sentiment one way or the other?

VICE CHAIRMAN CORRIGAN. No.

MR. PARTEE. Take a show of hands.

MR. FORRESTAL. You'd put foreign exchange first?

CHAIRMAN VOLCKER. Yes, "depending on the behavior of the aggregates, developments in the foreign exchange markets, conditions in domestic and international credit markets"--that way we could reverse those two--"and the strength of the business expansion and progress against inflation."

MR. RICE. I would prefer to see it stay as it is. People will be trying to figure out what we are trying to tell them. I don't want to tell them that because that's not how I see it.

CHAIRMAN VOLCKER. We leave it unless there are strong feelings and somebody wants to press the point.

MR. RICE. One less thing for market watchers.

CHAIRMAN VOLCKER. Possession is nine-tenths of the directive.

MR. PARTEE. And leave the funds rate at 6 to 10 percent. [Unintelligible].

VICE CHAIRMAN CORRIGAN. This is all in a framework in which the initial borrowing is $350 million.

CHAIRMAN VOLCKER. Initial borrowing in a $300 to $400 million range, starting at $350 million.

MR. PARTEE. And hope the funds rate will come down.

CHAIRMAN VOLCKER. If the discount rate were down, we presumably go toward the upper end of that range or even beyond, say, up to $450 million. If the discount rate doesn't go down, depending upon these other things, we might get down below the $300 million. The outside range is $250 to $450 million with an inside range of $300 to $400 million. Is that all comprehensible?

VICE CHAIRMAN CORRIGAN. Remember that man from Mars!

CHAIRMAN VOLCKER. Any further elucidation? I guess we will vote.

MR. BERNARD.

| | |
|---|---|
| Chairman Volcker | Yes |
| Vice Chairman Corrigan | Yes |
| President Black | No |
| President Forrestal | Yes |
| President Guffey | Yes |
| President Keehn | Yes |
| Governor Martin | Yes |
| Governor Partee | Yes |
| Governor Rice | Yes |
| Governor Seger | Yes |

CHAIRMAN VOLCKER. All right. We're going to leave for sandwiches.

END OF MEETING